# LONG-TERM FINANCING

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# FINANCING

JOHN F. CHILDS

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To SUSAN, my wonderful ten-year-old daughter, whose strong feeling about this book was that it took too much of Dad's time.

*INTRODUCTION*

# Why Another Book on Finance?

It is a fact that money calls the tune! The best business plans are worthless if the right amount of money can't be made available at the right time at the right price.

This book has been specifically designed to serve as a practical guide and working tool for the men who have to raise the money for their company. It will show you what you need to do, and what steps to take, to manage your share of the more than $425 billion of capital invested in United States corporations today. It will show you, step by step, how to do the actual financing and solve the many problems that you and the other financial officers of your company face.

Whether your company is large, of medium size, or a smaller one with an eye toward expansion, you will find practical guidance here on how to establish financial policies on which to base sound growth. Thus, this book will assist you in making correct decisions, so that your company and its owners, the stockholders, may derive the greatest benefit over the long run.

You will see how to set up financial safeguards against unforeseen developments in the securities market, in general business conditions, and in your particular industry. You will see why failure to erect such safeguards has been the undoing of corporations in the past.

Among some of the vital questions that are answered in the book are these: how much debt your company should carry; what your dividend policy should be; how best to sell senior securities and common stock; how to attract new investors; how to base your financial decisions on the wants of common stockholders. Soundly-run companies are relying today for their long-term financial growth on the answers to such questions.

One of the unique features of the book is a comprehensive treatment of the highly important field of investor relations. Success in this area is just as important as your capital structure, your dividend policy, or any other part of your long-term financing program.

A key part of the book is a detailed chapter covering the profit goals you should establish for your company when you go into new projects. The vital new factor of cost-of-capital has never before been developed in a similar manner in a book on finance. This, as yet a little-known factor in modern capital planning, can be the difference between costly, and even disastrous, missteps and successful expansion. It applies to small, privately-owned companies as well as to large, publicly-owned ones.

Many of the answers to your financial problems are given directly in the book. The pros and cons of various types of financing questions are set down, and specific guides to the best course of action are given. Many subjects in finance are controversial; that adds to their interest. Such subjects are squarely faced. They are so presented to assist you in reasoning through to your own conclusion for your particular company. If the book prevents you from making a superficial analysis, it will serve its purpose, even though your conclusion is quite different from that of the author.

This book is based on the author's firsthand experience in various fields of finance—experience gained by advising corporations, by living in Wall Street and through the exchange of ideas with men representing different aspects of finance. However, the inspiration for the book arose out of an unusual development—a unique type of Financial Seminar run in the heart of Wall Street for corporate executives.

The Seminars were developed by the author for the sole purpose of assisting senior executives to do a better job in long-term financing and to broaden their firsthand knowledge of finance. Each Seminar was limited to fifteen executives, so that each man would have an opportunity to ask questions and express himself. The Seminars included visits during the days to the many types of organizations which make up the financial community. An official of each firm explained what the corporate executive should know about his firm and gave his advice on financial matters. We didn't finish there. Evenings were devoted to group discussion and development of principles.

I am indebted to the many executives who attended and the many experts in Wall Street who gave their time to the Seminars. It is through contact with both that I was able to see the direction this book should take in order to fulfill a need. Many of both groups have given generously of their time in developing the book. I did not hesitate to seek the advice of specialists in various fields of finance in order to sharpen my focus on certain subjects and ascertain as far as possible that both sides of controversial subjects were fairly presented. Their suggestions assisted in keeping the book on a practical course and in making it conform to actual practice.

In the group who assisted with the book were members of investment banking firms, institutional investors, dealers in securities, representatives of the security rating agencies, corporation officials and many others in different fields of finance. Among those to whom I am indebted are the following:

Arbitrage—Stanley R. Shaw, manager of arbitrage department, Josephthal and Company; and Gustave L. Levy, partner in charge of trading and arbitrage expert, Goldman, Sachs and Company.

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Selling Senior Securities—A. B. Hager, Jr., Vice President, Louis A. Mahoney, Vice President, and Lincoln J. Patton, Halsey Stuart & Co. Inc. And also, on the competitive bidding example, Charles B. Delafield, Vice President, Consolidated Edison Company of New York, Inc.

Selling Senior Securities and Types of Securities—William R. Cowie, Vice President, The Equitable Life Assurance Society of the United States.

For assistance in various parts of the book—James A. Lyles, Senior Vice President, The First Boston Corporation.

For reviewing the entire book and making many helpful suggestions throughout—Robert E. Benson, Vice President, The Equitable Life Assurance Society of the United States; and Charles M. Enders, Partner, F. S. Moseley & Company.

This is not to say that these experts necessarily agree with all the material in the book. In view of the controversial nature of many financial questions, that would not be expected. However, to all of these people I wish to express gratitude for their invaluable advice. Thanks should also be given to the staff of my department—my assistant, Joan C. Merrell, for endless research and rewriting; and my associate, William E. Scott, for reviewing the final draft. This is not to imply that the views are in any way those of the organization for which I work.

Long-term financing is not a mysterious subject, but it is a fascinating one. This book strives to remove the mystery and enhance the fascination of this vital topic. Above all, it emphasizes practicality. This is not a book simply to be read and put on a shelf; it is a book to be used. It is so designed that you can turn readily to the subject of your immediate interest for timely guidance in your job of managing your company's finances and setting its profit goals.

John F. Childs

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*CHAPTER I*

# What, Who and Where

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What should long-term financing management encompass? We will start with an answer to that question and then point out the scope of the book, that is, the types of companies to which its ideas are most applicable. This chapter outlines who in a company should have an interest in the subject.

Two basic principles are also included. They are: the broad goal of finance, that is, to benefit the common stockholders; and the necessity of taking a long-term point of view in the type of finance with which we will be dealing. They may sound too simple to discuss, but they are necessary to show you the background upon which much of the reasoning in the book will be based—where it will be aimed.

## WHAT LONG-TERM FINANCING MANAGEMENT ENCOMPASSES

In the past, a knowledge of finance required an understanding of such matters as the different types of securities and how to go about raising money, or at least enough knowledge to talk intelligently to those whose profession it is to raise money—the investment bankers. With the industrial growth of our country two transitions have taken place which require a greater emphasis on the art of handling capital. First, capital, one of the elements of production, along with labor and raw materials, has been ever increasing as our industrial process has become more complex. It has resulted in our unsurpassed standard of living. The amount of capital per corporate employee now exceeds $14,000. It is bound to continue to increase. The success of many companies more and more depends upon their ability to make large capital expenditures.

Secondly, today practically everyone supplies capital either directly by personal ownership of securities, or indirectly through savings banks, insurance policies, etc. With the wealth of our nation spreading out on an ever-broadening base, the technique of raising and handling capital has become a major corporate task. This was not true at the start of the industrialization of our country when capital was provided to a great extent by the entrepreneur investing in his own company.

Corporate officials must never overlook their first responsibility to the owners of capital, but it is not at all theoretical to appreciate that the proper handling of capital has a vital effect on our economy as a whole. The flow of capital expenditures is basic in determining the economic stability and growth of our country. One need reflect only briefly on such an extreme financial catastrophe as occurred in 1929 to realize the important part the financial officer plays in preserving our system of private capital.

Thus, corporate executives must place an ever-increasing emphasis on the subject of handling capital. Today, the financial officer certainly would be inadequately equipped if all he knew was how to raise money. A new, broader concept has grown up over the years which encompasses three parts:

1. *Financing:* How to raise money—"financing" in its narrow sense as described above.

2. *Investor Relations:* How to keep investors, who have put up the money, informed about the operations of a company.

3. *Cost-of-Capital:* How much should be earned on plant, equipment and other assets in order adequately to compensate the investors —the basic goal for investment in new projects. It can also be called profit goal.

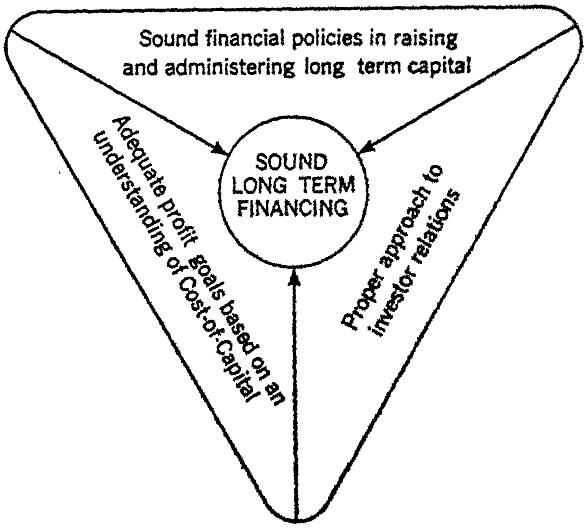
Two extensive chapters will be devoted to the latter two fields, which are not ordinarily included in long-term financing management. We will now discuss them briefly to show what they involve.

The field of investor relations has been receiving special attention only in relatively recent years. After the 1929 crash and the advent of the Securities and Exchange Commission in the 1930's, managements of publicly-owned companies began to realize that it was their obligation to reveal facts about the company to the stockholders. After World War II, many companies had to raise large sums of money for expansion purposes. This experience taught them that it was easier to raise money if the investing public were thoroughly informed about a company's operations. Investor relations evolved into a fine technique in some companies, but much of industry can still improve its performance.

Cost-of-Capital, as an effective management tool for industrial companies, is in its infancy —in about the same position as investor relations in the mid-thirties. It should not be confused with Return-on-Investment. The latter concept is being developed at a rapid pace as a control tool for management. It is the return actually earned on assets used to produce the return, or estimated to be earned on a new project. It represents what has happened or is estimated will happen. Cost-of-Capital is the basic gauge for determining what *should* have happened, and what should happen in the future.

Of course, every company must have some idea of what should be earned on investments in new projects in order to justify embarking on the projects. However, the bench marks used in most instances are quite rough and often not determined on a sound basis. Cost-of-Capital is the correct minimum bench mark. It is what investors require, in the sense of anticipate as a return to induce them to provide the capital in a competitive capital market. Relatively few companies seem to have a sound conception of it. Many industrial companies have raised their money internally. Thus they have not had occasion to come in contact with the true source of information on the subject —the capital markets. The subject is most difficult. There are many different views. Professors of finance are just beginning to realize its importance and putting some real thought into it. A knowledge of Cost-of-Capital is essential if the financial officer of a company is going to do a good job. And it is a most interesting field.

The following visual aid may give you a


Sound financial policies in raising and administering long term capital
SOUND LONG TERM FINANCING
Adequate profit goals based on an understanding of Cost-of-Capital
Proper approach to investor relations

better picture of how the author conceives that three components fit together in order to produce sound long term financing.

## THE SCOPE OF THE BOOK

This book is designed primarily for existing companies which face the problem of establishing financial policies on which to base sound long term growth. While we will concentrate on the medium-sized and larger companies which raise money publicly, the basic ideas set forth generally apply to smaller, closely-held ones. Most small companies hope to grow into large concerns some day and then they will have to raise funds publicly. An understanding of what the larger company has to face will make the transition from small to large much easier. Some privately-held small companies find the transition most painful. They may have done things in the past which turn out to be harmful and costly when they become larger and have to present their picture to outside investors.

All industries have their own financial problems; many use special types of financing. For example, the public utility and the railroad industries require special study because of their unique characteristics. The purpose of this book is to present material which is most applicable to all types of corporations; it will not try to cover individual industries per se. However, the utility industry will be drawn on for many examples. It makes large capital expenditures and does so much outside financing that it is a gold mine of information. Furthermore, there is sufficient uniformity among companies in the utility industry so that comparisons and averages can readily be made.

In practically all financial decisions, taxes play an important role. This book could not possibly include all tax angles. That is a field unto itself. However, the financial officer must know enough about taxes and their ramifications to know when to call in his tax expert and what questions to ask. On the other hand, a person well versed in taxes and not expert on finance can make some stupendous financial blunders. In making financial decisions, all alternatives which meet the test of sound principles of finance must be worked out, and then each should be thoroughly analyzed for its tax implications. In that order, a correct decision will be arrived at. Therefore, this book in no way suggests slighting the tax questions, but must of necessity stick to its principal aim.

## WHO MAY BE INTERESTED IN LONG-TERM FINANCING MANAGEMENT?

Who should undertake directly the three parts of long-term financing management? Primarily, they are the responsibility of the principal financial officer. He may have the title of Fnancial Vice President, Treasurer or, in some instances, Controller. In a large company the functions may be divided among a number of officials. No matter how divided, they all should be coordinated under one person. This book is generally directed at the principal financial officer. Throughout our discussion, we will think of him as the Financial Vice President no matter what his title.

If those under the Financial Vice President are to function properly and help him in coordinating the three parts of financial policy, they should know what his over-all task is, and what he is trying to achieve. The Financial Vice President will wish to make his aims and goals known to the rest of his staff.

In the top management, the President and the other senior officers at least need to understand the principles, because they must enter into the determination of financial decisions. Obviously, the Directors who have to approve or disapprove financial decisions must have an understanding of the subject. In any important financing, there will be outside experts working with the company—lawyers and accountants, among others. For them to be effective members of the team, they should have a real feeling for the subject. Finally, the owners, or at least the informed investors, ought to have proper standards by which to judge whether a company is correctly performing the financial function.

Thus, capital is too important today for its understanding to be limited to a few. The material in this book should be of use to those many persons who have a specific or general interest in finance. Whatever position you occupy, the more you know about finance, the more this book should be meaningful; but it is so designed that if you are a little rusty on the subject, there will be preliminary words before each major topic in order to start you off gently. If you work on finance regularly, you will quickly recognize these preliminaries and can skip over them with a glance. You will find a sufficient amount of other material requiring time and careful attention.

If you are an executive, you are bound to be a busy person. To assist you in reading and absorbing the material, you will find summary reviews in chart or outline form wherever possible. They may be used for reference and in your discussion of the subject with others.

## THE BROAD GOAL OF FINANCE

Now, what is our main goal? Let's start by expressing it in a few words:

> The goal of long-term financing management should be to handle all parts of finance so that the owners, or stockholders, will receive the greatest economic benefit over the long run.

As we have already mentioned, it sounds too simple to discuss. For it to have any significance, some explanation is needed. Basically, the word "benefit" means "profit." It is the job of the Financial Vice President to raise the capital and to do his part to see that the capital produces as large a profit as possible in a competitive atmosphere. In certain industries where monopoly of the particular service is necessary because of its nature—such as a utility—regulation must substitute for competition in order to guard against monopolistic profits on the one hand, and the wasteful higher service cost of duplication of facilities on the other.

The size of the rate of return on the capital is largely determined by the nature of the business and the ability of management to use the means of production, which are recorded on the asset side of the balance sheet. The liability side of the balance sheet shows how the management decided to raise the capital or, in other words, how the "capital pie" is divided among the various types of securities. It also allocates the earnings of the enterprise, because the earnings are distributed to the various classes of security holders. The Financial Vice President is in charge of this side. Changes in the liabilities do not immediately affect the company's ability to use the assets and thus realize earnings. However, the Financial Vice President may affect profits in many major and minor ways. Just review a few of them in terms of three parts of his job—financing, investor relations, and Cost-of-Capital.

Unsound financing may make it difficult to raise capital. The Financial Vice President must establish policies so that capital can be raised at almost any time. If an unexpected expansion program becomes necessary, he cannot say to his President, "No, we can't do that; we can't raise money at a reasonable cost today." Such an answer would certainly restrict profits. If he does his job properly, there are relatively few times when some form of security cannot be sold. Furthermore, he should establish policies which will result in financing at a reasonable cost. Investors naturally will require a higher return on securities of a company which has experienced financing trouble. That higher cost may persist for a long time, because investors do not change impressions quickly. It will have to be recovered in some way.

As to investor relations, many reasons will be found why a company should establish a well thought out program when that subject is more fully discussed. However, just one point alluded to before should be mentioned again: it is easier and less costly to raise capital if the investors are kept well informed.

Turning to Cost-of-Capital, the Financial Vice President should know at all times the cost for his company to raise capital. This cost must be covered in the selling price of goods just as much as the cost of labor. If the Financial Vice President advises his company on too low a goal when expansion is being considered, unprofitable projects may be launched. On the other hand, if his figure is too high, profitable avenues may be neglected. Thus, the job of the Financial Vice President is by no means unrelated to profits. Almost everything he does has a direct or indirect bearing on profits and should be thought of in such terms.

The emphasis on the word "profit" may sound to some people as though sight has been lost of the ultimate purpose of our system of private enterprise, which is, of course, to produce a large quantity of goods for consumption, at the lowest average cost and price, and distribute the income fairly among the elements of production. There is no incompatibility between profit and the purpose of our system; the search for profit is, in fact, the motivating force. However, the term "profit" must be interpreted as applying entirely to the long run. In order to achieve the goal in the long run, consideration must be given to fair treatment of employees, fair treatment of customers, good public relations, and the responsibility of the company to the welfare of the community. These factors may not be under the jurisdiction of the Financial Vice President, but he must have them in mind in performing his functions, otherwise the goal of earning a fair profit in the long run will not be achieved. In other words, the profit goal must be consistent with the ultimate purpose of producing goods for consumption. A short-term, excessive profit might ultimately defeat this purpose. Furthermore, there must be free competition in unregulated industry so that the profit margin will be limited and the consumers protected. Nothing in this book should be interpreted as suggesting a "shyster profit" approach.

We have discussed the matter of the profit element, but in the thought above, the word "benefit" rather than "profit" has been deliberately employed. Why? To answer this question, it is well to consider briefly what the investors want more specifically. If, in the long run, the common stockholders benefit, the senior security holders will likewise have their wants satisfied. However, we might consider the wants of both types of security holders, the senior holders and the common stockholders.

The senior holders include those who own securities such as bonds and preferred stock. The company has fixed payments to them. Obviously, they want to be certain that they will receive what the company has agreed to pay them—interest or preferred dividends. If their security is a bond, they also expect to receive payment of principal when it becomes due. However, they want more than just this. Since they may wish to dispose of their security, its market price is a matter of prime importance. Therefore, they desire that the company's credit be maintained at a high level so that the price of the senior security will hold up in the market.

Now, as to the position of the common stockholder, he is the owner. No one comes after him to afford him any protection. He assumes the first risk. To visualize the position of the common stockholder, place him in his true relationship as the owner. Don't think of him as an outside party. What does the common stockholder want and get? To understand what his expectations are, think of a small incorporated company with all the stock owned by one person. It is clear that the single owner is entitled to all the earnings, after expenses and charges on any senior securities. It is his choice whether to take these earnings out of the business in the form of dividends, or leave them in so that they will build up the value of his investment. The important point: it is the owner who is entitled to all the earnings in the first instance. The common stockholder in a large, publicly-owned company is basically in no different position. It is this right to the total earnings per share which the stockholder of such a company buys. The earnings plowed back will build up the book value of his investment. If those retained earnings are profitably invested in new projects, the company's future earnings should increase. The risk taken by the common stockholder can be compensated for only by potentialities of appreciation through growth in earnings. Management must work to accomplish this end.

We must go one step further. The common stockholder of a publicly-owned company is vitally interested in the market price of his stock. While the earnings retained in the business belong to him and should build up his investment, the only things he can get are dividends and change in the market value of his stock when he sells it. This is where the word "benefit" enters into the principle stated above. Not only must the management of a company attempt to produce satisfactory profits over the long run, but it must also follow financial policies which will produce the best market price for the stock over the long run. It is these two factors combined which are referred to as *benefit* for the common stockholder.

## THE LONG RUN VIEW—A NECESSITY IN LONG TERM FINANCING

One more principle should be kept in mind throughout the book. We have already used the term "long run," but it is so important in practically all financial policies that it deserves emphasis:

> Evaluate all the possible effects of each financial decision in both the short and the long run, with most emphasis on the long run.

This, also, may sound ridiculously simple, but if you think only in terms of the short run and do not consider adequately the long run, your decisions may ultimately be disastrous for your company.

What is the short run? It is the number of years ahead in which you can forecast earnings and cash budgets and reasonably well foresee the outlook for your company. What is the long run? It is the period farther ahead during which you cannot make forecasts, because it is not possible for the human mind to predetermine what may happen to a company and its finances in five, ten, fifteen, twenty, or twenty-five years or more. We are dealing with long term financing, not short term. Your stocks will be outstanding indefinitely and your long term debt will extend past the foreseeable future.

How can you indicate in a few simple words that you are a poor Financial Vice President? Assume that you have just sold a bond with a 25-year maturity. Then you make the statement, "Twenty-five years is a long way off, and we can't waste time now thinking about the problem of the maturity. Furthermore, I will be retired by then." You may be retired, but your company won't be, and your stockholders won't be. Someone may be stuck with a problem that you created. Some corporate "shot gun weddings" or mergers, as well as some bankruptcies, have been due to this failure. Naturally, the Financial Vice President doesn't have a crystal ball, but he should recognize this fact in establishing financial policy.

The Financial Vice President will need determination. He will probably have to do a large amount of persuading of other vice presidents, the president and the directors, in order to convince them of the long-run possibilities. This is particularly true if others in the organization are either the promoter types who can only see through rose-colored glasses, or are hell bent on making money or a name for themselves before they retire, without sufficient regard for the ultimate consequences of their actions.

Is this evaluation of the long run merely theory? Not by any means! In fact, most of this book will lose its significance unless you appreciate that it isn't theoretical. You will see why this is so in the next chapter.

*CHAPTER II*

# Capital Structure

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What broad types of long term securities and how much of each should you use to raise capital and form your capital structure? It is a basic decision you should make before you take the step actually to sell a specific security. Because it is a difficult subject, some corporate officials gloss over it and, by so doing, may place their company in jeopardy.

Capital structure is the cornerstone of a company's financial policy, and that is the reason why it is placed here at the beginning of the book. The Financial Vice President has been referred to as the architect of finance. What he establishes must prove to be a sound structure, one commanding respect of investors far into the future, under all types of conditions.

Since the subject is difficult, we will begin gradually. If you are working on finance regularly, you will want only to skim over this first part. At the bottom of page 10 we will start to reach the meat of the problem. Following that page, we will outline and explain the factors which should be weighed in arriving at a sound conclusion about debt ratio for your company. We will set up standards in terms of ratings and how they can be translated into the amount of debt. Next, we will shift to the controversial question of preferred stock. In order to give you a comprehensive picture of the subject, many figures are included as we proceed and also towards the end of the chapter.

## BASIC TYPES OF SECURITIES

The differences in the types of securities are contained in the terms which express the obligations of the company to the security holders. There is a wide assortment of securities, with two major divisions: debt and equity.

Debt may take such form as mortgage bonds, debentures, or long-term notes. One of the features which distinguishes debt from equity is that the former carries an obligation to pay principal and interest. The default of this obligation can place the company in bankruptcy.

Equity can be broken down into two types: preferred and common. Preferred stock is a form of equity. It does not entail any fixed obligation the default of which can lead to bankruptcy. Preferred dividends do come ahead of any payment on the common stock. If preferred dividends are not paid, preferred stockholders may acquire certain rights which may give them a voice in the management coequal with the directors who were elected by the common stockholders. There are other characteristics of preferred stock which make it quite different from debt.

Common stock, or common equity, represents the remainder, or ownership, after any debt, preferred stock or any other intermediate type of security.

You will find that your ability to reason in the field of finance will be immeasurably simplified if you will think in terms of these three basic types of securities, and look at other securities as a combination or variation of them. You will be in a better position to evaluate the advantages and disadvantages of a security for a particular purpose. We will consider other types of securities in Chapter V, but for this chapter, and in fact for the basic thinking throughout the book, these are the main types with which we will be concerned.

## AN ACTUAL COMPANY'S CAPITAL STRUCTURE

Capital structure includes all long-term obligations and equity, that is, any item of permanent capital. The expression "long-term obligations" refers to debt with a maturity of one year or more. Obligations with less than one year maturity are set forth in current liabilities. Debt with a maturity of only slightly over one year is not really permanent capital. Nevertheless, a dividing line has to be established, and the choice of one year is to distinguish it from working capital or short-term borrowings on a seasonal basis which are liquidated in normal turnover of business. If a company relies too heavily on short-term debt, so that it becomes a permanent fixture, then such borrowings should be viewed accordingly and included in capital structure.

Some capital for most types of companies is actually furnished through items in current liabilities, such as accounts payable, taxes payable, etc., but these items have their counterpart in current assets. Like short-term borrowings, they are liquidated in the regular turnover of business. We will not be much concerned with them.

Let's take a look at an actual capital structure and see what we mean by "dividing the pie," so that we will be talking about the same thing. The following are figures[1] for a com-

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[1] The consolidated balance sheet, as reported by Moody's Investors Service (000's omitted), was as follows:

| *Assets* | | |
|---|---|---|
| Cash | $ 36,295 | |
| U. S. Gov't Securities | 16,712 | |
| Receivables, Net | 61,668 | |
| Inventories | 69,516 | |
| Total Current Assets | | $184,191 |
| Investments and Other Assets | | $ 10,284 |
| Property, Plant and Equipment | 305,407 | |
| Less: Depreciation Reserve | 142,375 | |
| Property Account, Net | | $163,032 |
| Deferred Charges, intangibles, etc. | | 6,115 |
| **Total** | | $363,622 |

| *Liabilities* | | |
|---|---|---|
| Accounts Payable | $ 40,356 | |
| Accrued Taxes | 3,888 | |
| Other Current Liabilities | 15,527 | |
| Total Current Liabilities | | $ 59,771 |
| Insurance and Other Operating Reserves | | $ 10,080 |
| Debenture 2⅞'s, due 1981 | | $ 47,000 |
| Subsidiary Notes Payable | | $ 1,200 |
| Capital Stock ($15 par) | 73,500 | |
| Capital Surplus | 38,427 | |
| Earned Surplus | 133,644 | |
| Total Capital Stock | | $245,571 |
| **Total** | | $363,622 |

pany in the food business. It had a simple capital structure consisting principally of debentures, rated *Aa* by Moody's Investors Service, and common stock.

| | | |
|---|---|---|
| *Debt* | | |
| Debenture 2⅞'s, due 1981 | $47,000,000 | |
| Subsidiary Notes Payable | 1,200,000 | $48,200,000 |
| *Common Equity* | | |
| Capital Stock ($15 par—4,900,000 shares) | $73,500,000 | |
| Capital Surplus | 38,427,000 | |
| Earned Surplus | 133,644,000 | $245,571,000 |
| Total Capitalization | | $293,771,000 |

The capital structure can be expressed in simplified form as shown below; it is the meat of what we are now interested in, and this is the manner in which we will generally state capital structure:

| | |
|---|---|
| Debt | 17% |
| Common Equity | 83 |
| | 100% |

This form shows how much equity capital is available to protect the senior obligations—in other words, how much the owners are using their own capital or relying on outsiders' money.

Numerous questions may arise as to what should be included in capital structure.[2] It is unnecessary to be concerned with small items which do not affect the percentage relationships in total more than a full percentage point. This is not a book on accounting, but it might be well to mention three points.

1. You will note that capital surplus and earned surplus are included as part of the equity of the common stockholders. Earnings available for the common stock belong to the common stockholders. When they are retained in the business rather than paid out in dividends, they are an addition to the common equity just as though new money had been raised by the sale of additional shares.

2. Preferred stock, if it is no par, will be carried on the company's books at a stated value. For purposes of capital structure analysis, it should be included at the liquidating value and a corresponding adjustment made to the common equity if the stated value differs from the liquidating value.

3. The asset side of the balance sheet should be carefully scrutinized for items of dubious worth which do not represent tangible assets, such as "good will." If such items exist, a reduction of the common equity will have to be made in order to arrive at a realistic picture. In the past, some companies indulged in book writeups of assets which required an adjustment of both sides of the balance sheet and thus inflated the equity.

## EARNINGS ARE BASIC TO VALUE OF A SECURITY

Securities are of little value without earnings. Therefore, let's take a moment to look at the earnings available for the security holders in our previous example. They were as shown on next page.[3]

The total income, which is the balance of income available for all investors, represents a return of 9.3% on the total capital structure. Of that income, 6% was paid out in interest to the bond holders and 94% was left for the common stockholders. Slightly more than half

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[2] An important item in analysis of capital structure is the amount and type of leases, particularly when they are used as a medium of financing. To avoid added complication, no consideration is given to them at this point. They will be discussed in Chapter V, Types of Securities.

[3] The consolidated income statement from which these figures were taken, as reported in Moody's Investors Service (000's omitted), was as follows:

| | |
|---|---|
| Net Sales | $941,326 |
| Cost of Goods Sold | 820,149 |
| Selling, Gen., Admin. & Other Expense | 74,378 |
| Provision for Doubtful Accounts | 1,171 |
| Net Earnings | $45,628 |
| Other Income | 5,357 |
| Total Income | $50,985 |
| Interest | $ 1,707 |
| Income Taxes | 23,728 |
| Net Income | $ 25,550 |
| Common Dividends, Paid in Cash | 13,697 |
| Balance after Dividends | $ 11,853 |

| | |
|---|---|
| Total Income | $50,985,000 |
| Less: Income Taxes | 23,728,000 |
| Balance for Total Capital Structure | $27,257,000 |
| Interest | 1,707,000 |
| Common Dividends | 13,697,000 |
| Balance after Cash Dividends | $11,853,000 |
| Earned per Share | $ 5.21 |
| Dividends per Share, Paid in Cash | 2.80 |
| Percent Earnings Paid Out in Dividends | 54% |
| Times Fixed Charges Earned, before Income Taxes | 29.5 |
| Times Fixed Charges Earned, after Income Taxes | 16.0 |

of the common earnings was paid out in cash dividends.

## DIVIDING THE CAPITAL STRUCTURE PIE

Now we will begin to dig into our present problem, that is, to determine what constitutes an appropriate capital structure.

Three steps are required: First, decide in broad terms how much should be debt, if any, and how much equity, including both preferred and common. Then decide how much of the equity, if any, should be preferred. Finally, within these broad divisions, establish what specific types of securities should be used for a particular financing program.

This chapter will cover the first two steps: how to "divide the pie" in terms of the three classifications—debt, preferred, and common equity. The reasoning necessary to solve this problem will illustrate the fundamental considerations required in deciding upon the use of other securities. As previously stated, Chapter V will cover individual types of securities.

The "division of the pie" between debt and equity is probably the most important financial decision to be made by the management of a company. Why should the ratio of debt to total capital structure be 10%, or 20%, or 30%, etc.? Perhaps there should be no debt at all. On what do you hang your hat to make the decision?

We have mentioned some broad generalities which the Financial Vice President should have in mind, but we have given no specific advice, because there are no obvious guideposts. It is for this reason that some managements make this decision on a relatively superficial basis. Anyone can see that debt is a cheap form of capital, with interest deductible for tax purposes. Anyone can go into debt, that is easy. But how much debt is right, and what is meant by "right"? You must expect that the answer will require much reasoning.

## CONVENIENT GUIDES TO AMOUNT OF DEBT-BOND RATINGS

Our basic consideration in determining the amount of debt is the quality which we wish that debt to represent, because the quality will have a direct effect on the cost of the debt and the ability of the company to finance in the future; and it will influence the other securities junior to it, particularly the common stock.

As an aid to our thinking, we can make good use of the quality ratings assigned to debt securities by the three rating agencies, Fitch Investor's Service, Moody's Investors Service, and Standard and Poor's Corporation. How these rating agencies operate will be explained in Chapter VI. There it will be seen that a rating signifies the quality or inherent risk in a security. For our present purpose, the ratings are a valuable working tool. In fact, they are almost indispensable. If they did not exist, we would need to develop something similar.

There is no simple way to tell by the use of a few ratios what a bond will be rated.[4] The

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[4] A brief description of how Moody's Investors Service describes ratings as reported in its Manuals is as follows:

"The purpose of Moody's Ratings is to provide the American investor with a simple system of gradation by which the relative investment qualities of bonds may be noted.

"Gradations of investment quality are indicated by rating symbols, each symbol representing a group in which the quality characteristics are broadly the same. There are nine symbols as shown below, from that used to designate least investment risk (i.e., highest investment quality) to that denoting greatest investment risk (i.e., lowest investment quality):

***Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C***

ratings are a result of judgment based on a careful study of all facts which have both a direct and indirect effect on the quality of a company's securities. They are not an exact guide to quality because they cannot be determined on a mathematical basis, but the long experience of the agencies does minimize the possibility of error. Their ratings are widely accepted by investors and by the financial community. Furthermore, ratings are the best tool available for explanatory purposes and they will give us a good start.

How can these ratings be used as an aid to determine capital structure? In the first place, they give us a concept or terminology to express what we want our debt to be in terms of quality. If our debt is publicly held, it will be rated for everyone to see; if not publicly held, it will still be viewed in terms of what rating financial experts will estimate that it represents, because ratings are so much apart of financial lingo. After we have decided how we want our debt to be rated, we must translate the rating into the approximate amount of debt that this will permit as a percentage of total capital structure—the debt ratio.

The symbols which Moody's uses for the first four ratings and excerpts from their definitions,[5] which may help you categorize them, are as follows:

| | |
|---|---|
| *Aaa* | ". . . the best quality . . . 'gilt edge' . . ." |
| *Aa* | ". . . high quality by all standards . . ." |
| *A* | ". . . higher medium grade . . . elements may be present which suggest a susceptibility to impairment some time in the future." |
| *Baa* | ". . . lower medium grade . . . lack outstanding investment characteristics, and, in fact, have speculative characteristics as well." |

We will not be concerned with the lower ratings and therefore will omit their definitions.

The other agencies use different symbols. We will not include the same type of material by the other agencies because it is sufficiently like Moody's for our present purpose. As is stressed in Chapter VI, the agencies should be treated on a similar basis. Also as explained in that chapter, the following terminology is used in financial circles to represent the four quality ratings discussed above without reference to any one of the agencies: *Triple A, Double A, Single A, Triple B.*

For a particular company the rating decreases as the debt is increased, because the debt burden becomes heavier and the risk greater. All other factors are constant; the amount of debt is the only variable. But be-

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"Since ratings involve a judgment about the future, on the one hand, and since they are used by investors as a means of protection, on the other, the effort is made when assigning ratings, to look at 'worst' potentialities in the 'visible' future rather than solely at the past record and the status of the present. Investors using the ratings should not, therefore, expect to find in them a reflection of statistical factors alone. They are not statistical ratings but an appraisal of long term risks, such appraisal giving recognition to many non-statistical factors."

[5] Complete definitions by Moody's Investors Service for the first four ratings:

*Aaa* "Bonds which are rated *Aaa* are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as 'gilt edge.' Interest payments are protected by a large or by an exceptionally stable margin and principal is secure. While the various protective elements are likely to change, such changes as can be visualized are most unlikely to impair the fundamentally strong position of such issues.

*Aa* "Bonds which are rated *Aa* are judged to be of high quality by all standards. Together with the *Aaa* group they comprise what are generally known as high grade bonds. They are rated lower than the best bonds because margins of protection may not be as large as in *Aaa* securities or fluctuation of protective elements may be of greater amplitude or there may be other elements present which make the long term risks appear somewhat larger than in *Aaa* securities.

*A* "Bonds which are rated *A* possess many favorable investment attributes and are to be considered as higher medium grade obligations. Factors giving security to principal and interest are considered adequate but elements may be present which suggest a susceptibility to impairment sometime in the future.

*Baa* "Bonds which are rated *Baa* are considered as lower medium grade obligations, i.e., they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics, and, in fact, have speculative characteristics as well."

tween companies other factors are not equal, and there may be considerable difference in debt ratios for the same rating. In order to get some idea of the relationship of debt ratio and rating for a particular type of company, it is necessary to make a study of other companies as nearly similar as possible. How close the correlation is between debt ratios and ratings will depend on the nature of the business.

For example, from the relatively stable electric industry, which can carry more debt than most types of companies, we may get a clue as to how ratings vary with debt ratios. Typical ratings for bonds of three electric companies with the five year average capital structures,[6] 1955-1959, are as follows:

| Bond Rating | *Cleveland Electric Illuminating Company*<br>*Triple A* | *Public Service Company of Oklahoma*<br>*Double A* | *Georgia Power Company*<br>*Single A* |
|---|---|---|---|
| Bonds | 46% | 49% | 55% |
| Preferred | 8 | 17 | 13 |
| Common & Surplus | 46 | 34 | 32 |
| | 100% | 100% | 100% |

As implied above, the quality of a bond does not so much depend on assets as it does on earnings. However, if two companies earn the same rate on the capital structure and otherwise have the same characteristics, then the one with the lower debt ratio would obviously have the better earnings protection for interest charges.

Even in the relatively stable electric utility field there are numerous examples of variation in ratings for approximately the same debt ratio. This is so because there are innumerable factors that may have an effect on the amount and quality of the earnings.

In the industrial field, where there is much more variation in the factors that affect the quality of a company's securities, there may be a wide spread in bond ratings between two companies with the same debt ratio. Or conversely, there may be a wide spread in debt ratio between two companies with the same rating. Furthermore, since there are relatively few ratings to cover a wide variation in quality, there is a band for debt ratio within which a rating may fall, rather than a specific percentage. So, in constructing a policy for your company, you will not be able to, and fortunately won't need to, refine your conclusion relating to the proportions closer than a few percentage points.

## EFFECT OF BOND RATINGS ON YIELDS

Since we have talked so much about ratings, let's digress a moment to see what they mean in terms of interest rates.

As the quality of bonds decreases, the cost of debt money increases with the added risk. For example, Moody's average of yields on outstanding issues of industrial bonds by ratings for the ten years 1950-1959 was as follows:

| | *Aaa* | *Aa* | *A* | *Baa* |
|---|---|---|---|---|
| 1959 | 4.27% | 4.36% | 4.49% | 4.91% |
| 1958 | 3.61 | 3.78 | 3.91 | 4.59 |
| 1957 | 3.76 | 3.89 | 4.03 | 4.79 |
| 1956 | 3.30 | 3.39 | 3.47 | 3.84 |
| 1955 | 3.00 | 3.11 | 3.16 | 3.47 |
| 1954 | 2.82 | 3.02 | 3.09 | 3.40 |
| 1953 | 3.12 | 3.23 | 3.27 | 3.55 |
| 1952 | 2.88 | 2.93 | 3.01 | 3.20 |
| 1951 | 2.78 | 2.82 | 2.90 | 3.04 |
| 1950 | 2.55 | 2.59 | 2.66 | 2.86 |

These figures do not represent the actual interest cost at which a company could raise new debt money for the various ratings. New issues have to be sold at a lower price than similar outstanding issues. This will be explained in Chapter VII, "Selling Senior Securities."

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[6] From Moody's Investors Service.

The spread in yield between the ratings widens as the ratings decrease in quality. For example, in 1959, the spread between *Aaa* and *Aa* was 0.09%; between *Aa* and *A*, 0.13%; and between A and Baa, 0.42%. This spread will vary from time to time depending upon market conditions. During times when interest rates are increasing, the spread tends to open up like an accordion. For example, the spread between the average yields for *Aaa* and *A* was 0.22% in 1959, compared with 0.11% in 1950 when rates were lowest during the ten years.

## ARGUMENT IN FAVOR OF HIGH DEBT

You certainly know that there is more to determining capital structure than the unstudied argument in favor of high debt, which is as follows:

> The cost of debt money is cheap as compared to equity, and interest is deductible for tax purposes. For example, if we assume that long-term debt might be sold at an interest rate of 4%, that would mean a net cost of only 2% after allowing for an assumed Federal income tax rate of 50%. As will be explained in Chapter X, on Cost-of-Capital, common stock may cost 10%. Thus the cost of capital raised through common stock is over five times greater than the net cost of bond money. For this reason, it is contended that a company should rely heavily on debt.

Why is this an unstudied approach? A company's debt rating cannot be better than the best, that is, *Triple A*. At least for the discussion at this point, it seems that there is nothing to be achieved by reducing the debt below the point at which it will receive a *Triple A* rating. The cost of debt money will not be decreased and more expensive equity money will have to be substituted for the decreased debt. However, as debt is added beyond the point of the best rating, *Triple A*, risk is added to the entire "capital structure pie."

Consider the effect that debt has on equity. Logically, if the rating falls as debt is increased and the interest rate rises, it follows that the equity will sell at a lower ratio to earnings. Debt may even affect dividend policy. This all means a higher equity cost.

Furthermore, the argument above in favor of high debt is superficial for the following reasons:

1. It combines some elements of cost which are totally different and must be considered separately.
2. It uses incorrect cost figures.
3. It leaves out fundamental financial policy considerations.
4. It is an argument which appears correct in boom times, but proves unsound over the long run.

The discussion thus far has given us some background on which to open up our thinking about the appropriate type of capital structure, but we haven't yet answered the question as to which rating is to be preferred and how much debt that permits. In order to assist you in your further thinking on the problem and so that you can get a broad picture, let's take a look in the next section at how it must be attacked, using an outline form, which appears on next page.

## THE TWO PERIODS OF TIME TO WEIGH IN DETERMINING DEBT RATIO

First of all, note in the outline the two distinct periods of time—the Foreseeable Future and the Unforeseeable Future—in which capital structure must be tested. The Foreseeable Future is the period in which a company can make forecasts with some degree of certainty, possibly up to five years for a relatively stable type of company; the Unforeseeable Future is the period further ahead. In Chapter I, emphasis was laid on the importance of evaluating all financial moves in the long as well as the short run. In fact, it was set forth as a principle. Here is where that principle must be applied. It is what we have in mind by the Unforeseeable Future.

## OUTLINE SUMMARY OF CONSIDERATIONS IN CAPITAL STRUCTURE FORMATION

### FORESEEABLE FUTURE

5 years ahead

Capital structure should be tested in this period, but because long-term securities are outstanding past the foreseeable future, the period further ahead is most important.

CONCLUSION: A large well-situated company will achieve the best results in the long run; if its goal is to maintain a conservative capital structure and a high quality standing for its securities. Bond ratings are a good guide for preliminary thinking.

### UNFORESEEABLE FUTURE

More than 5 years ahead

Bonds mature in this period.
Equity securities will still be outstanding.

FOUR LONG-RUN X-FACTORS

1. Poor Security Markets
2. Bad Business Conditions
3. Trouble in the Industry
4. Trouble for the Particular Company

SIX DETERMINANTS (*1 and 2 most important*)

1. *Borrowing Reserve*
   Suggests low debt ratio with high credit rating on debt.
2. *Financial Insurance*
   Suggests low debt ratio with high credit rating on debt.
3. Cost-of-Capital
   Correct reasoning on this point does not suggest a different policy from the above two factors in the long run.
4. Leverage
   Suggests use of as much debt as possible, but not to the extent to negate Determinants 1 and 2.
5. Tax Savings
   Suggests use of as much debt as possible, but not to the extent to negate Determinants 1 and 2.
6. Pools of Capital
   Suggests use of various basic types of securities if appropriate.

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## THE FOUR LONG-RUN X-FACTORS

How can we test capital structure in the Unforeseeable Future, since by its very nature it is so nebulous? The answer is that we must make allowance for the adverse situations a company might encounter in this period. They can all be summarized under four headings which we have chosen to call the Four Long-Run X-Factors:

1. Poor Security Markets,
2. Bad Business Conditions,
3. Trouble in the Industry,
4. Trouble for the Particular Company.

Allowance for these four factors must be made in setting up the debt ratio. A company must be able to raise capital at all times on a satisfactory basis without hurting its financial standing, and also meet any existing maturities, even though any one or all of the four Long-Run X-Factors plague the company. An individual is not a pessimist if in managing his own personal finances he allows for possible sickness in the future; he is just being sensible. This same idea applies to a company.

## THE SIX DETERMINANTS

There are Six Determinants to evaluate. They are listed in the outline with brief comments under each. You will note that in the left hand column a conclusion is given. Let's skip this for the moment and go on to a complete discussion of the Six Determinants. You can turn back to the outline for review.

Here are the Six Determinants in the order that they are given in the outline (the first two are the most important):

### *1. Borrowing Reserve*

Borrowing reserve is put first, because it is by far the most important. It might also be referred to as the ability to finance and raise capital.

In our competitive industry today innovations appear often and unexpectedly; a company cannot prosper if it has to defer new design and new manufacturing techniques. The best of long-range plans may have to be altered quickly. With capital replacing labor and our industry geared to complicated production techniques requiring large capital outlays, it is essential that a company have the ability to raise capital in large quantities. In an industry such as the utility industry, direct competition may not be present to force changes, but if consumers' needs are not met, the unfavorable reaction may be felt through adverse regulatory action.

A company cannot keep on hand a large amount of cash or short term investments in order to be in a position to take care of large capital expenditures. This would be uneconomical. Short term bank loans may be used for long-term capital temporarily, but ultimately they must be repaid through long-term securities. Therefore, the normal procedure for raising such capital funds is to sell long-term securities. Hence, a company must be in a position to sell some type of security.

The common stockholder is the first to suffer when adverse conditions occur. The other security holders, from the junior to the more secured, suffer in inverse order of their seniority. The most secure are, of course, those who hold the debt issues. From the company's point of view, the easiest and least costly type of security to sell under adverse circumstances is debt. It follows that a company must maintain a margin or cushion of borrowing power to provide for financing at times when it is impossible to sell stock or other types of junior obligations on a satisfactory basis. This is what is known as borrowing reserve.

Managements cannot foresee, let alone dictate, the conditions under which capital may have to be raised. They may have to face the problem when one or more of the long-run *X*-factors is present—poor security markets, bad business conditions, trouble in the industry, and trouble for the particular company. For example, in 1955 and 1956, competition became severe in the automobile industry, and some companies were in adverse circumstances. Security markets and business conditions were excellent. Thus, only two adverse elements were present, yet witness what happened. Some automobile companies had their backs to the wall in fierce competition, and they were further crippled by weak financial positions.

If a company has a large amount of debt outstanding, the maturity may occur just when it needs to do financing to raise new capital. This is an added burden. Furthermore, if the existing debt was sold during a period of low interest rates and has to be paid at maturity during a period of high rates, the increased charges may appear as an unhappy surprise.

A further point must be kept in mind. A company should be able to finance under adverse conditions without having to experience a prolonged period of reduced credit standing and depressed market prices for its securities. In evaluating the quality of a company's securities, investors will study how it was able to ride out a storm and whether at that time it encountered difficulties. Investors are not quick to forget, and evidence of weakness will be reflected for a long time in the market price of a company's securities.

Capital structure is relatively inflexible. When a company runs into trouble and wishes to raise capital, it cannot then decide to reshuffle its securities. It is stuck with whatever wise or unwise decisions have been made in the past.

What causes trouble in view of the above? The answer is simple—the incurring of too many senior obligations during good times when there was no need for such action. The only way to meet adverse conditions when they arise is to keep your house in order when things are going well.

What does this mean in terms of financial policy? It can best be described by referring to our guides—the ratings—having in mind the definitions attached to each.

The *Triple A* rating is the best. Next there is *Double A*, which is close to *Triple A* and still represents good quality. For the *Single A* rating the definition includes the following statement: "Elements may be present which suggest a susceptibility to impairment sometime in the future," and for the Triple B, "Certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and, in fact, have speculative characteristics as well." They may be considered semi-speculative.

It would not appear that a large, well-known company should have as its goal to use debt to the extent that it would have a rating as low as *Triple B*. As will be seen below, it is questionable whether *Single A* is fully satisfactory.

Obviously, a company with *Triple A* credit has real borrowing reserve. It can pile on some more permanent debt before its rating would be lowered to *Double A*. And a company with *Double A* rating has some borrowing reserve, because it can add some permanent debt and still not be in too bad a position if it slips to the *Single A*. But what about a company with debt rated *Single A?* Its credit is not really poor, and in good times it can readily sell any type of security. Even under moderately adverse conditions it would not be too badly off. But does it have borrowing reserve under really adverse conditions? The answer to that question must contain an element of uncertainty. If it added more permanent debt, the rating would slip to *Triple B*. Let's not go any further down the scale. A company with *Triple B* type of credit may be dependent on fair weather conditions to be able to finance satisfactorily.

Thus, we can stop with the first two ratings, *Triple A* and *Double A*, if we are going to be sure of borrowing reserve.

The discussion above has been based on the assumption that a company adds more debt permanently when it resorts to borrowing reserve. In fact it should plan to restore the borrowing reserve within a reasonable period of time by repayment of that debt through some form of serial maturities, or sinking fund, or by an increase in the equity.

What does the above discussion mean in terms of debt ratio, or the amount of debt a company can carry in good times? We will be more specific on this point subsequently. Let's first go over the other determinants.

### 2. *Financial Insurance*

Financial insurance is almost as important as borrowing reserve. It appears to be similar to borrowing reserve but actually it is not. A company may encounter a fundamental change that will affect its basic position. Maintenance of a high credit standing while the company is in good shape provides financial insurance against such an eventuality. Borrowing reserve allows for temporarily increasing debt without hurting the company's credit standing. Financial insurance allows leeway for a reduction in rating without any change in the amount of debt if a company experiences a decline in its character.

The ratings are designed to take into consideration the possibility of some adverse developments. They are not changed at the first instance of a storm. However, when a company does run into extended trouble, its rating will be lowered. If a company has *Triple A* credit standing, it has real insurance. It can drop to *Double A* and still be in a good position. If it is *Double A* at the start, it has room to fall to *Single A*, and not be too badly off.

However, if it has debt rated *Single A,* does it have financial insurance? Hardly, unless it is accepted that *Triple B* is satisfactory. Both borrowing reserve and financial insurance lead to the same conclusion as to what ratings represent a satisfactory financial policy.

### *3. Cost-of-Capital*

Cost-of-Capital is a most complicated subject. It is explained in Chapter X. The discussion here presupposes some knowledge of Cost-of-Capital. If you are not familiar with the subject, you will probably need to return to this determinant for review after you have read Chapter X.

Cost-of-Capital would not be a problem at this point in financial policy if capital structure consisted only of common stock. The problem arises because of the need to decide whether the use of some senior securities may lower the Cost-of-Capital. If the discussion which follows is properly understood, it will be apparent that in some instances the inclusion of other types of securities may raise the Cost-of-Capital rather than lower it.

Much stress in determinants 1 and 2 above was laid on the fact that an existing capital structure may become relatively inflexible at a given time; therefore, a policy must be followed which will hold good under both favorable and unfavorable circumstances. So must Cost-of-Capital be based on an average of all types of circumstances, not just on boom times when superficially it would appear that most of the capital would have to be raised. Capital is being continuously accumulated as surplus earnings are plowed back into the business. Think of all of the difficulties which a company may have to face over a period of years and the effect such circumstances have on Cost-of-Capital.

How do we answer the question as to how much senior obligation will produce the lowest cost? The answer must first be approached on the basis of economic principles and logic. It then must be tested, if possible, with statistics. However, if you thoroughly understand the scope of the problem, you will realize that the statistical proof is a most difficult one. If you do not thoroughly understand the scope of the problem, you will be certain to arrive at incorrect answers by using inadequate statistics.

Why have we stated that if debt or senior obligations are added beyond a certain point, they add risk to the entire capital structure? These are the reasons:

a. Earnings for the common are farther out on the limb, and will be subject to greater variability.

b. There is the weakening effect, or added risk to the common stock, because senior securities may limit the payment of dividends if the company runs into difficulties.

c. Borrowing reserve may be adversely affected, thus crippling the company's ability to finance satisfactorily under all types of circumstances. Likewise, financial insurance may be eliminated.

d. There is the more remote possibility of default in interest or principal and the resulting disastrous consequences of bankruptcy for all securities.

Presumably, debt could be added up to the point just before the *Triple A* rating would fall to *Double A* and no risk would be added to the enterprise. However, as more debt is added, the rating falls, risk is added and interest costs go up. This is clearly apparent from our previous discussion. Since the added debt pushes the equity securities farther out on a limb, their quality declines and an even greater return on them will be required by investors. Figures may best illustrate the above.

Assume the following:

a. The capital structure for our industrial company will be varied to include only common or a combination of debt and common.

b. Debt can be added up to the following percentages and achieve the following ratings:

| | *Debt as a percentage of total capital structure* |
|---|---|
| *Triple A* | 10% |
| *Double A* | 20 |
| *Single A* | 30 |

The range in debt ratios will, of course, vary with different types of companies, but the same general principles will apply.

c. The cost of debt money, on an average under all types of conditions, would be as follows:

| | *Cost Rate on Debt* |
|---|---|
| *Triple A* | 4.00% |
| *Double A* | 4.15 |
| *Single A* | 4.35 |

d. The cost of common remains at 10% until the equity falls below 90% and then increases as follows:

| *Common Equity As a Percentage of Total Capital Structure* | *Cost Rate on Common* |
|---|---|
| 100% | 10% |
| 90 | 10 |
| 80 | 12 |
| 70 | 14 |

On the basis of these assumptions the Cost-of-Capital would be as follows:

| | *Capital Structure* | | *Rate* | *Cost-of-Capital* |
|---|---|---|---|---|
| | Debt | 0% | | |
| | Common | 100 | 10.00% | 10.0 % |
| | | 100 | | 10.0 |
| *Triple A* | Debt | 10 | 4.00 | 0.40 |
| | Common | 90 | 10.00 | 9.00 |
| | | 100 | | 9.40 |
| *Double A* | Debt | 20 | 4.15 | 0.83 |
| | Common | 80 | 12.00 | 9.60 |
| | | 100 | | 10.43 |
| *Single A* | Debt | 30 | 4.35 | 1.31 |
| | Common | 70 | 14.00 | 9.80 |
| | | 100 | | 11.11 |

Of course, the conclusion from these figures is obvious: the capital structure with Triple A bonds produces the lowest over-all Cost-of-Capital.

Perhaps you think that we have increased the cost rate on the common too much as the common equity ratio decreased. We can revise these figures and bring out the point still further. In the examples above, it was assumed that the cost rate for common was the same with 100% common and with *Triple A* debt. Because of the "built in" security of all common, it would seem reasonable that investors might be willing to pay a slightly higher price (higher price—earnings ratio, lower earnings—price ratio) for such a stock as compared to a company with *Triple A* debt. Let's assume that the rate would be 10% for an all-stock company and increase to 10.5% with common equity reduced to 90%. We will further adjust the cost on the common for the higher debt ratios so that the over-all cost would be the same as for the *Triple A*. The resulting figures would then be as follows:

| | *Capital Structure* | | *Rate* | *Over-All Cost* |
|---|---|---|---|---|
| | Debt | 0% | | |
| | Common | 100 | 10.00% | 10.00% |
| | | 100 | | 10.00 |
| *Triple A* | Debt | 10 | 4.00 | 0.40 |
| | Common | 90 | 10.50 | 9.45 |
| | | 100 | | 9.85 |
| *Double A* | Debt | 20 | 4.15 | 0.83 |
| | Common | 80 | 11.28 | 9.02 |
| | | 100 | | 9.85 |
| *Single A* | Debt | 30 | 4.35 | 1.31 |
| | Common | 70 | 12.20 | 8.54 |
| | | 100 | | 9.85 |

From these figures it can be seen that it takes only a small increase in the cost of common to lose any apparent advantage of using low cost debt to reduce Cost-of-Capital. In view of the advantages of low debt, is there any question which is the best type of capital structure on the basis of the above figures? At least these figures are a partial answer to the unstudied statement made on page 00. "Long-term debt might be sold at an interest rate of 4%, that would mean a net cost of only 2% after allowing for an assumed Federal income tax rate of 50% . . . common stock money may cost 10%. Thus, the Cost-of-Capital raised through common stock is over five times greater than the net cost of bond money. For this reason, it is contended that a company should rely heavily on debt."

What may we conclude from the above discussion? The following:

a. Both logic and economic principles would lead us to expect some increase in the cost of common as debt is increased beyond a certain point.

b. As debt is increased it takes only a small increase in the cost of common to offset the savings resulting from the use of higher debt.

c. In view of the advantages of borrowing reserve and financial insurance, it does not appear that the use of high debt, supposedly to reduce the Cost-of-Capital, is much of an argument against a strong capital structure. Its appeal is primarily a matter of opportunism in fair weather conditions.

As for more exhaustive treatment of Cost-of-Capital, we will wait until Chapter X. It will be pointed out in that chapter that there is a basic economic principle to the effect that Cost-of-Capital is determined by the nature of the enterprise and its risk, and not by the way the "capital structure pie" is divided. In principle, there is no change in the average dollar cost.

We have not touched on the effect of the income tax savings resulting from interest charges, nor allowed for it in the above figures. Determinant 5, discussed hereafter, covers this area.

### *4. Leverage*

What is leverage? In a few words, it consists of financing with senior obligations so as to increase the rate earned on the common equity. It is also referred to as "trading on the equity." C. Norman Stabler, financial writer of the *New York Herald Tribune*,[7] explained it this way:

> If you can put your own $100 in your business and make 20% on it in a year, that's fine, and you have $20, but no leverage. If you can borrow another $100 from a friend, at 6% and make 20% on this borrowed money also, you clear $14 on his hundred plus the $20 on your one hundred. That's leverage.
>
> It's nice business, when everything is going up. It's not so nice when things go the other way, because, if you make only 3% on your friend's $100 or nothing at all, or perhaps sustain a loss, he still wants his 6%.

Let's explain it with a few more simple figures. Assume that a company earns 9.85% on an investment of $100,000,000, which was the rate we used in our last example. Assume further that it is financed solely with common stock and 1,000,000 shares are issued at $100 per share. Then the rate earned on the common would be 9.85% and earnings per share would be $9.85. If it paid $5.00 per share in common dividends, the payout ratio would be 51%. Now let's use some leverage and finance the $100,000,000 by selling $40,000,000 of 6% preferred stocks[8] and the balance of $60,000,000 as common stock represented by 600,000 shares at $100 per share. Then preferred dividend payments would total $2,400,000 annually, leaving $7,450,000 for the common. This would represent a return of 12.42% on the common, or $12.42 per share. With a $5.00 dividend on the common, the payout ratio would be 40%. Summarized, these two situations would be:

| | *100% Common* | *40% Preferred 60% Common* |
|---|---|---|
| Earnings on Total Capitalization at 9.85% Rate | $9,850,000 | $9,850,000 |
| Preferred Dividends | —0— | 2,400,000 |
| Balance for Common | $9,850,000 | $7,450,000 |
| Return on Common | 9.85% | 12.42% |
| Number of Shares | 1,000,000 | 600,000 |
| Earned per Share | $9.85 | $12.42 |
| Common Dividends per Share | $5.00 | $5.00 |
| Common Dividend Payout Ratio | 51% | 40% |

Thus the common would be in a more risky position because of the preferred stock, but due to leverage the earnings per share would be greater. As long as the earnings held up or increased, the common stockholder would get more earnings per share. How simple, easy and effective leverage is; or is it?

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[7] *New York Herald Tribune*, Aug. 27, 1956.

[8] Preferred stock is used rather than bonds to avoid the question of the Federal income tax savings due to interest. This question will be discussed as our next Determinant.

Assume that the company runs into trouble and earnings fall to 5% on total investment, what then? Here are the sad results:

| | *100% Common* | *40% Preferred 60% Common* |
|---|---|---|
| Earned on Total Capitalization at 5% Rate | $5,000,000 | $5,000,000 |
| Preferred Dividends | —0— | 2,400,000 |
| Balance for Common | $5,000,000 | $2,600,000 |
| Return on Common | 5.0% | 4.3% |
| Number of Shares | 1,000,000 | 600,000 |
| Earned per Share Common | $5.00 | $4.33 |
| Common Dividends per Share | $5.00 | $5.00 |

The capital structure with leverage failed to earn its common dividend and it would be in a progressively worse position if earnings continued to fall.

Those in favor of leverage will say: "Instead of using preferred, use debt and take advantage of the savings in taxes due to interest charges. Then you get the real advantage of leverage." As explained in the footnote in the previous page, preferred stock rather than debt was used so as to treat leverage separately from the tax factor which will be discussed next.

Just consider what 40% debt might do to borrowing reserve and financial insurance for an industrial company. The same general principle applies to other types of companies. Norman Stabler expressed it well: "It's nice business when everything is going up. It's not so nice when things go the other way. . . ."

There are actually two reasons why stockholders may benefit from leverage when profits are rising. It means more money for the stockholders as illustrated above. Secondly, because some investors like leverage during a boom, they may be willing to pay a price for the stock in relation to the earnings greater than is justified by the added risk caused by the leverage. In other words, the price-earnings ratio will be higher in good times than is warranted by the risk involved. However, when profits start to fall, the reverse occurs, and a company with leverage becomes less attractive.

There are those investors who like leverage. There are those investors who can afford to play with leverage—the professionals who can watch a company carefully and sell their securities before trouble starts. Companies wholly owned by one or a few stockholders may wish to indulge in it, providing they know what they are doing. But the management of a company which has a large stockholder list must remember that it will have stockholders as long as the company exists. Some stockholders are going to be left "holding the bag." It may be the small uninformed stockholders who suffer. A company's management must consider the effect of leverage with both rising and falling earnings, and a rising and falling stock market.

The above discussion tells us what leverage is, its advantages and disadvantages, but it doesn't tell us what to do about it. The answer seems obvious. The misuse of leverage arises only when a company uses so much of senior securities that its credit is adversely affected. It does not involve the use of debt which will permit maintenance of a high credit rating. Those who urge the use of leverage are generally thinking in terms of overly high debt level. Such a policy flies right in the face of borrowing reserve and financial insurance. That would be unsound financial policy.

### 5. *Tax savings*

Tax savings resulting from the use of debt is advanced as the major item in favor of high debt. Of course, interest charges on debt do reduce Federal income taxes. This is a relatively simple point, but it should be treated separately. Then it can be determined if it offsets the arguments in favor of a conservative approach as suggested by borrowing reserve, financial insurance, and Cost-of-Capital over the long run.

In the first instance, don't view the tax savings as a reduction in Cost-of-Capital. Such an approach may develop mathematical equivalence, but, as will be seen in Chapter X on that subject, the Cost-of-Capital is more easily understood if it is first visualized from the point of view of how much has to be paid investors. The company, not the bondholder, gets the advantage of the fact that interest is deductible for Federal income tax purposes.

Taxes are a cost of doing business. The selling price of a product must include an amount to cover that expense. Therefore, to the extent that debt is appropriate in a capital structure, it should be used in order to reduce the expense of taxes. However, the decision to use debt should not be based on the reverse reasoning of piling on all the debt possible merely because of the tax savings.

Let us illustrate the effect of the tax factor alone by using the same basic figures with which we ended the discussion on Cost-of-Capital, and assuming a Federal income tax rate of 50%. The over-all cost as respects payments to investors is maintained constant for various debt ratios, for the following reasons, which have already been mentioned:

The economic risk of the enterprise basically determines the cost-of-capital and not the way the "capital structure pie" is divided. No financial expert would suggest the use of excessively high debt in order to reduce the overall Cost-of-Capital. Such higher debt adds an element of risk and should require that the return to the common stockholder be higher to compensate for the greater risk. Consequently, there is logical economic justification to suggest that as the debt is increased beyond a certain point, the overall return should be higher because of the added risk to the enterprise. However, for our purpose here, we are assuming the same over-all return.

The over-all cost as respects payment to security holders and the corresponding rate that the company would have to earn before taxes in order to pay taxes, and also the security holders, would be as follows for various debt ratios:

| | *Capital Structure* | | *Rate* | *Over-All Cost* | *Income Required before Federal Income Taxes in Percent of Capital Structure* |
|---|---|---|---|---|---|
| | Debt | 0 | | | |
| | Com. | 100% | 10.00% | 10.00% | 20.00% |
| | | | | 10.00 | |
| *Triple A* | Debt | 10 | 4.00 | 0.40 | |
| | Com. | 90 | 10.50 | 9.45 | |
| | | 100 | | 9.85 | 19.30 |
| *Double A* | Debt | 20 | 4.15 | 0.83 | |
| | Com. | 80 | 11.28 | 9.02 | |
| | | 100 | | 9.85 | 18.87 |
| *Single A* | Debt | 30 | 4.35 | 1.31 | |
| | Com. | 70 | 12.20 | 8.54 | |
| | | 100 | | 9.85 | 18.39 |

The figures show that the tax savings result in relatively little difference in the pre-tax figures, when weighed in relation to the compelling arguments for a sound capital structure. The "income required before Federal income taxes in percent of capital structure" for Triple A is only 2.3% more than Double A, and 4.9% more than Single A. This increase becomes even smaller when translated into the effect on selling price. For illustrative purposes only, let us assume that the income required before Federal Income taxes represents 20% of sales, then the increases in Cost-of-Capital as noted above of 2.3% and 4.9% would be only 0.46% and 0.98% respectively in terms of the sales price. This would decrease as the capital element decreases in terms of sales.

### 6. *Pools of Capital*

Capital is relatively fluid; it tends to seek the highest return commensurate with risk. However, there are some investors who are restricted to certain types of securities. For example, life insurance companies and savings banks invest largely in fixed income securities such as bonds. Other investors may buy mostly stocks. Some can buy either bonds or stocks.

At times, because certain investors may have available funds, whereas others may not, there is not complete fluidity. For various reasons, the common stock market may be excellent, while the bond and preferred market may be poor, and vice versa.

There is a spread in the return which investors will accept between bonds, preferred stock and common stock as well as a spread between the different qualities of each type of security. These spreads vary from time to time depending upon economic conditions and the demand and supply of funds for investment.

If a company can use more than one type of security, it is in a better position to draw on the different pools of capital as conditions may suggest. This presupposes that a company first satisfy the other determinants discussed above in designing its capital structure. This is not to suggest that a company go to the other extreme and have a complicated capital structure. Simplicity in financing is to be preferred.

## CONCLUSION FROM DETERMINANTS AS TO GOAL FOR QUALITY OF DEBT

Now that we have covered all the determinants which should be weighed in establishing a capital structure, our conclusion is that the arguments in favor of a conservative policy far outweigh those in favor of high debt. For a large, well-situated company, this means keeping debt within limits so that it will be rated *Triple A* or *Double A*.

In the relatively stable electric utility field, there are many companies with debt rated *Triple A* and *Double A*. In the industrial field, there are only a handful of companies with *Triple A* debt. The rating agencies in their best judgment do not feel that, even with low debt, many industrial bonds should be given the highest rating. The *Double A* category is good for an industrial company.

Does this mean that all companies should try to be *Triple A* or *Double A?* No, because some companies have characteristics which would prevent them from being *Triple A* or *Double A* even if they used only a little debt. This may suggest that such companies should use no debt. Perhaps they shouldn't, but at times debt may be useful and necessary. It does suggest that such companies should not be chronically heavily in debt. Furthermore, that type of company should not hesitate to include a sinking fund in its debt which will provide for rapid repayment and not leave a large amount of debt to mature in the distant future.

What about large, well-known industrial companies which follow a policy of no debt whatsoever, even though they could have some debt and still be *Triple A* and *Double A?* You may disagree with them on the basis of the above discussion, but it is difficult to criticize such companies too severely. They have a "built in" reserve which may come in quite handy. It is certainly worth something. We will have more to say on this point later.

Now we must decide specifically what particular debt ratio is suitable to a given company.

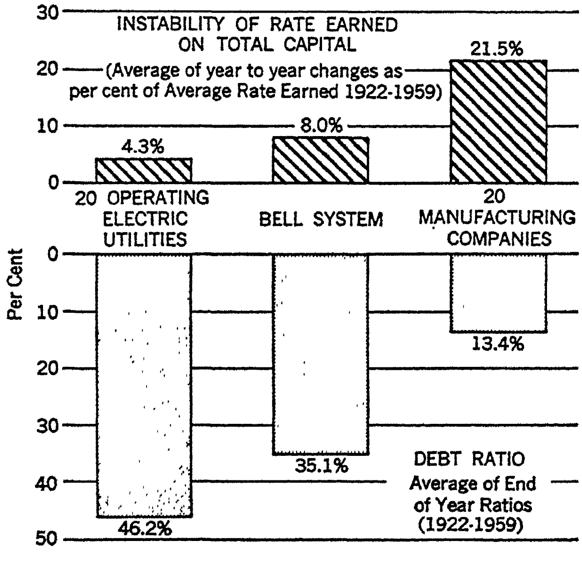
## ABILITY TO USE DEBT COMPARED WITH RISK

**The nature of the business and the inherent risks connected with a company affect its ability to carry debt. It is the amplitude of variations likely to occur in the earnings of the business, under changing economic conditions,**

that determines to a great extent how much debt can be carried while the business maintains a satisfactory credit rating. The full range of potential variation may or may not have been reflected in the experience of the past. A company faced with, but inexperienced in the risk of widely fluctuating earnings, may be forced into serious difficulties in periods of low earnings. Such a company cannot carry as high a debt with its accompanying high annual payments as a company with relatively stable earnings. As has been previously emphasized, an analysis of all surrounding factors is required to evaluate the potential risks.

The chart below shows the debt ratio to total capital structure for some electric, telephone, and manufacturing companies, compared with the earnings experience as measured by the relative instability of rates earned on total capital for the period 1922-1959. This chart illustrates how debt ratio might be expected to vary inversely with risk.

Earnings Instability and Debt Ratio



Data for the electric industry cover the 20 largest operating utilities[9] at the end of 1949 for which generally consistent data are available since 1922. They are used because comprehensive data are not available for the entire industry for the period studied. These 20 companies, however, comprise between 40% and 45% of the privately-owned electric industry in the U. S. Data for the telephone industry[10] reflect operations of American Telephone and Telegraph Company and its subsidiaries, known as the Bell System. Long-term data for the manufacturing industry as a whole are unavailable; so the 20 largest manufacturing companies[11] in 1949 were used, for which comprehensive data are available.

Instability, as shown on the top grid of the chart, is measured by the degree of year-to-year fluctuation in the rates earned on total capital, expressed as a percentage of the average rate earned from 1922 through 1959. Reading from left to right, it was 4.3%, 8.0% and 21.5% for the three groups respectively.

The lower grid of the chart shows debt ratios decreasing from 46.2% for electric, to 35.1% for telephone, and to 13.4% for manufacturing, as the earnings become more and more unstable.

## TESTS TO ARRIVE AT CONCLUSION ON DEBT RATIO FOR A SPECIFIC COMPANY

It has been stressed that there is no categorical answer as to how much debt a certain rating may permit, because debt ratings depend upon all the surrounding factors. The Financial Vice President should first attempt to arrive at an answer by comparing all the important financial ratios of his company with other similar types of companies which have rated bond issues outstanding. This will require some knowledge of financial analysis in order to apply the proper judgment to the ratios.

If the Financial Vice President does not have this knowledge, he may need to seek outside assistance. He may wish to obtain the independent opinions of at least three financial analysts who have had long experience in analyzing securities in the field in which the company operates. He should not ask them how much debt the company should have. They may not be thinking in terms of a long-range goal, or they may be leverage-minded. He should merely ask them what rating would be achieved with various debt levels.

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[9] The long-term debt of the electric utility companies is rated as follows: 6 companies with *Aaa* issues only; 9 companies with *Aa* only; 2 companies with both *Aaa* and *Aa;* 2 companies with *Aa* and *A;* and 1 company with *A* only.

[10] The long-term debt of the subsidiaries of Bell System is rated *Aaa* and *Aa*. A few subsidiaries have no debt. The parent company's debt is rated *Aa*.

[11] The industrial companies had debt rated as follows: 2 companies with *Aaa* issues only, 4 companies with *Aa* only, 3 companies with *A* only, 1 company with *B* only, 8 companies with debt held privately, and 2 companies with no debt.

After an amount of debt has been tentatively determined as the long term goal, then the next step is to test check it in terms of borrowing reserve. You will wish to decide the extent to which debt could be increased temporarily in order to meet the company's potential emergency capital requirements. There should be sufficient leeway so as to provide adequate borrowing reserve. Assume a reasonable interest rate and then check the protection afforded interest charges with both the amount of debt as a goal and also with the borrowing reserve added under favorable, average and unfavorable conditions for the company. This can be done by assuming certain earnings levels based on past operations if such a comparable record is available. Allowance, of course, must be made for possible differences in the character of the company in previous years and the fact that if debt is issued to raise capital, it should eventually add new earnings.

If it is contemplated that the debt will contain a sinking fund, then similar tests should be made for total charges of interest and sinking fund requirements against cash flow including depreciation. Sinking fund or repayment schedule should be large enough to restore the borrowing reserve within a reasonable time. Finally, the same type of analysis should be made to determine the effect on junior securities, including dividend payments on the common stock and earnings per share of common.

It is surprising how some executives think that they have allowed for the four long-run X-factors when they say, "We have encountered such and such trouble in the past and survived." This is worthwhile information but it may not sufficiently take account of all possible future developments. This is particularly true if a company has had a successful past. A proper test requires not only analysis of how the company was affected by adversities in the past, but also how it might be affected in the future—a real opportunity for the application of sound judgment.

## DISTRIBUTION OF CORPORATE BONDS BY RATINGS

At this point it seems worthwhile to pause and observe the rating classification for companies with publicly-held rated debt.

Moody's Investor's Service rates a total of 2,461 bonds of corporations with a total par amount of about $46.9 billion dollars. It may be noted that each separate issue under an indenture is counted as a separate bond. The classification by ratings at December 31, 1959, was as follows:

| | *Railroads*<br>*784 Issues*<br>*$8.8 Billion*<br>*Amount*<br>*Principal* | | *Public Utilities*<br>*1,250 Issues*<br>*$28.0 Billion*<br>*Amount*<br>*Principal* | | *Industrials*<br>*427 Issues*<br>*$10.1 Billion*<br>*Amount*<br>*Principal* | | *Combined* | |
|---|---|---|---|---|---|---|---|---|
| | % of Principal Amount | % of Number of Issues | % of Principal Amount | % of Number of Issues | % of Principal Amount | % of Number of Issues | % of Principal Amount | % of Number of Issues |
| *Aaa* | 7% | 9% | 19% | 12% | 13% | 3% | 16% | 9% |
| *Aa* | 9 | 20 | 50 | 40 | 30 | 13 | 38 | 29 |
| *A* | 21 | 33 | 22 | 34 | 27 | 22 | 23 | 32 |
| *Baa* | 25 | 19 | 7 | 10 | 18 | 24 | 12 | 15 |
| *Ba* and lower | 38 | 19 | 2 | 4 | 12 | 38 | 11 | 15 |
| | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

In the combined total, 54% by principal amount were rated *Aaa*, or *Aa*, and another 23% *A*, so that only 23% had a lower rating. In terms of number of issues, 38% were rated *Aaa* or *Aa* and another 32% *A*, leaving 30% in the lower ratings. One of the reasons there are a greater number of issues with lower ratings than by principal amount is that smaller companies tend to have lower ratings. This is more pronounced in the industrial field, where 43% by principal amount were rated *Aaa* or *Aa*, and another 27% *A*, so that 30% had a lower rating; in terms of number of issues, 38% were rated *Aaa*, *Aa*, or *A*, with the balance being *Baa* or lower.

These figures do not give a complete picture of the financial policy followed by all industrial companies, because they do not include those with debt privately held and the great number with no debt at all.

## IS YOUR COMPANY DIFFERENT?

Each company differs from another in one or more ways. It is a matter of the degree of difference which will determine how each may have to be treated as regards capital structure. Some fall into a more or less general pattern; others will be at the extremes.

We have already noted that electric companies can carry more debt than most industrials. As a further example of extremes and of how a company must be analyzed carefully for its special characteristics, a word about department stores and finance companies.

Department stores have three special characteristics: 1. Relatively stable type of business as compared to industrial companies, 2. A large inventory which can be readily liquidated without too much loss, and 3. Receivables from customers which, after adequate reserves, represent assured value. As a consequence, this type of company has tended to carry more debt in one form or another, including financing of receivables and leases on fixed assets. Including all of these forms of debt, the percentage in relation to total capital structure may be as high as 50%, and even higher in some companies. This is not to suggest that such percentages necessarily provide sufficient borrowing reserve and financial insurance.

Finance companies are perhaps at the greatest extreme. Their assets represent an assured fixed income which will automatically turn into cash as time rolls on, provided there are adequate allowances for reserves for delinquencies. The assets are in the form of a relatively liquid debt obligation. Hence, they can have a high amount of debt outstanding themselves. A ratio of debt to total capitalization of 70% is not uncommon.

But if you think your company, because of its special nature, can stand more debt, be sure that your reasoning is based on sound analyses. Don't fail to see its true nature as a result of being too close to it.

## SHOULD YOU BE A SLAVE TO RATINGS?

How close should a company hue to the line suggested above? If a company is large and well known it is hard to see any logic in deviating. Size of company is very important in ratings. A relatively small company will receive a poor rating no matter how low its debt ratio. Therefore, ratings are not a good direct guide for the smaller companies. Since lack of size does add an element of risk, this is one reason for a smaller company to keep its senior securities at a lower ratio than a similar large company. Generally, in developing a policy for a smaller company it is essential to think in terms of what the picture would be like were it a large one. Think in terms of our guides, the ratings. Translate them into debt ratio; then make the transition to the smaller company, having in mind that such a company should have less debt than a large one. For a small company, instead of trying to be too precise and use ratings, you might wish to think in more general terms to represent quality such as: high grade credit, medium grade and poor grade.

Is it always possible to do just the proper thing in financing? No. Even unorthodox methods may be the right thing to do under certain circumstances. For example, when a new company is started, capital will have to be raised in any feasible manner. But the point is that a company should make as near an approach to the proper goals as possible; then, as the opportunity presents itself, they should be reached. In other words, the goals should be in the minds of the management, and they should be made known to investors; this in itself will have a very salutary effect.

There is a matter of balance in taking steps to improve a poor capital structure. This means more equity and less debt. While the suggestion has been made to proceed as fast as possible, there is such a thing as going too fast, because investors are "from Missouri." They won't give a company credit for any improvement until some time has passed. If a company makes a quick move, say by replacing debt with equity, the earnings for the common may be diluted. At least for a time, investors will not evaluate the securities on the basis of the improved capital structure. A gradual pace will prevent too much immediate dilution and will fit the pattern of investors' acceptance of the improved situation.

Privately-owned companies can take a somewhat different approach. The owners provide the common stock money and if the need arises, they can add more as they see fit, without regard to market price of the stock. This assumes, of course, that they have the necessary funds. If not, more strict adherence to a sound financial approach is essential. There is another reason why a privately-owned company may take a different approach. The slow acceptance of improved credit standing by public security holders which occurs in a publicly-owned company does not exist in a privately-held company. Owners of a private company are close enough to the picture to evaluate the immediate situation without the wait-and-see approach of an outsider.

While it must be recognized that there may be a difference in the debt policy for a privately-owned company, nevertheless this should not be taken as a recommendation for such a company to go heavily into debt. The risks of too much debt are serious and anyone following such a policy should realize the inherent dangers. Furthermore, if a privately-owned company expects to change to a publicly-owned one, it must be remembered that its past record will count in its favor or against it as the case may be. If a private company expects to become publicly held, it should anticipate the transition by recognizing the difference.

## COMPANIES WITH NO DEBT

There are a number of companies which have no debt even though they could carry some and have it highly rated. One of the outstanding examples is E.I. Dupont de Nemours and Company. That company has stated [12] the following as among its basic principles governing financial policy: "First and most elementary is to stay out of debt."

In a publication of Standard and Poor's Corporation, 295 large companies were listed under the title "Single Capitalization Desirable." [13] Those companies had only common stock. The comments in the publication expressing an investor's point of view are rather interesting:

> The common stocks listed in the table . . . are rather unique in that they are not preceded by any bonds, long-term bank loans, minority interests or preferred stocks. While the "ideal capital structure" for one company will not be suitable for another, the ability of a company to adhere to a simple capitalization devoid of senior securities in an era of prosperity is a mark of distinction. Other things being equal, a company with common stock as the sole capitalization is in a safer position than one with a more complex capital structure. There is no fixed drain on earnings before they filter down to the common stockholder, and no danger of default in the event profits should drop sharply. Such companies usually are in a better position to pay and maintain liberal dividends.

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[12] ———, Du Pont, the Autobiography of an American Enterprise, "Finance" page 131. E.I. Du Pont de Nemours & Co., Wilmington, Delaware, 1952.

[13] Standard and Poor's Corporation, "The Outlook," August 6, 1956 (Vol. 28, No. 32) page 673.

> It does not necessarily follow, of course, that companies with prior capital issues are undesirable investments. Utility common stocks, for example, are highly regarded, yet almost invariably are preceded by large bond and preferred stock issues. In recent years, many companies have preferred to go more heavily into debt to finance their expansion. There has been a definite tax advantage, since interest is deductible in determining taxable income, the cost of borrowed money has been relatively low, and such financing involves no dilution of equity. As a general rule, however, a clean capitalization is an important investment consideration.

> The selected stocks . . . should appeal to the true investor. Even if these companies had bonds or preferred stocks outstanding we are confident that such issues would be assigned high quality ratings. As it is, they have only common stocks, which have sole claim to earnings and assets. In a sense, therefore, it may be said that these stocks have some of the attributes of senior capital issues. Dividends have been paid without interruption for long periods, with some of the companies tracing their first payments back to the 1800's. It follows that stocks of this caliber carry less risk than the average common stock and can provide a basic framework for any well rounded portfolio. The group has defensive characteristics, but also offers possibilities for appreciation in response to long-range growth of the economy.

## THE OTHER SIDE OF THE STORY, FAVORING HIGH DEBT

Since financial policy can't be determined by pure mathematics but must rest on judgment, there are many different views from black to white and with all the shades in between.

Those who prefer high debt may contend that this chapter did not properly present the story. All the arguments favoring the use of debt have been stated: debt is cheap, interest is deductible for tax purposes and it provides leverage. All the figures are there for you to see; you may apply judgment as you see fit. Those favoring high debt say: "It is only the old fogies who favor a conservative policy. They avoid taking appropriate risks so they can sleep nights. That type of person has a fear complex and is a natural pessimist."

Going into too much debt may look good in the short run, but you are liable to land up dancing to the tune of the senior security holders rather than playing the tune that is best for your company. Careful thought beforehand may save some unneeded worry after it is too late. Whatever policy you decide on, do not think it is a simple question.

## WHAT CONSTITUTES DEBT?

Before we leave debt, it may be well to say a further word as to what debt is, in case you are struggling with calculating the ratio in a complex situation. We have already said that it includes mortgage bonds, debentures, and long-term notes, in other words, any form of fixed income obligation with a maturity of more than one year.

Bank loans with a maturity of less than one year are included in current liabilities. However, it has already been pointed out that if bank loans are not regularly liquidated each year in the course of business, it might be necessary for analytical purposes to throw them in with long-term debt. In such a situation a company is, in effect, relying on banks for its long-term capital.

As will be noted when we discuss financing with lease arrangements, there is a great controversy as to whether lease financing is a form of debt. You may disagree, but at this point let it stand that the author believes it is a form of debt and that it should be included in the capital structure at a reasonably capitalized amount for analytical purposes.

If a company sets up a subsidiary and then uses the subsidiary as a means for debt financing, the amount of debt of the subsidiary should be included with the parent company debt, providing the parent company is obligated to furnish fixed payments to the subsidiary to support the debt. In this situation the credit of the subsidiary is dependent on payments by the parent company and not on the assets of the subsidiary alone. The same applies if a company sets up a dummy company with the equity owned by an outsider.

Income debentures may not have the appearance of debt on the surface. However, a careful analysis of their restrictive provisions and contingencies clauses may show that they are a form of debt and that they should be included with debt.

This is not to say that all debt is to be looked at as exactly alike. The various forms may place different restrictions and burdens on a company. For this reason, if there are many types of debt it may be well to show the percentage of each separately, as well as the total, in an analysis of capital structure. But do not let hidden debt cause you improperly to evaluate capital structure, and do not slide types of securities which are burdensome, like debt, over into the equity group. Specific types of securities will be more fully covered in Chapter V.

## PREFERRED STOCK'S PLACE IN CAPITAL STRUCTURE

At the start of this chapter we said that there were three fundamental types of securities—debt, preferred and common. Now let us consider preferred stock, the second step in "dividing the pie."

Preferred stock is sometimes referred to as being "neither fish nor fowl," neither debt nor common, and therefore no good. Some people even refer to it as "bastard" security. When you hear a Financial Vice President talk that way, you may feel that he is tying on to a glib phrase rather than putting on his thinking cap. All types of securities represent media through which to raise capital. Whether they serve the purpose depends on: (a) how they fit the capital structure based on general financial principles discussed above, (b) on all their restrictive provisions, and (c) on what basis they can be sold in the market.

Preferred stock has the advantage of not being a fixed obligation which will put the company in bankruptcy and it does not directly hurt borrowing reserve or financial insurance, two very important points in its favor. However, it does come ahead of common and if used inappropriately or to too great an extent even where it is fitting, then it will impair the common stock with the ensuing disadvantages.

In deciding whether to use preferred, the basic question is whether it should in some degree be substituted for common. Do not fall into the wrong type of reasoning by trying to decide on the use of preferred stock rather than debt, or vice versa. Debt has an entirely different character from stock. First decide, as emphasized above, how much, if any, debt there should be. Then seek an answer to the possible use of preferred stock.

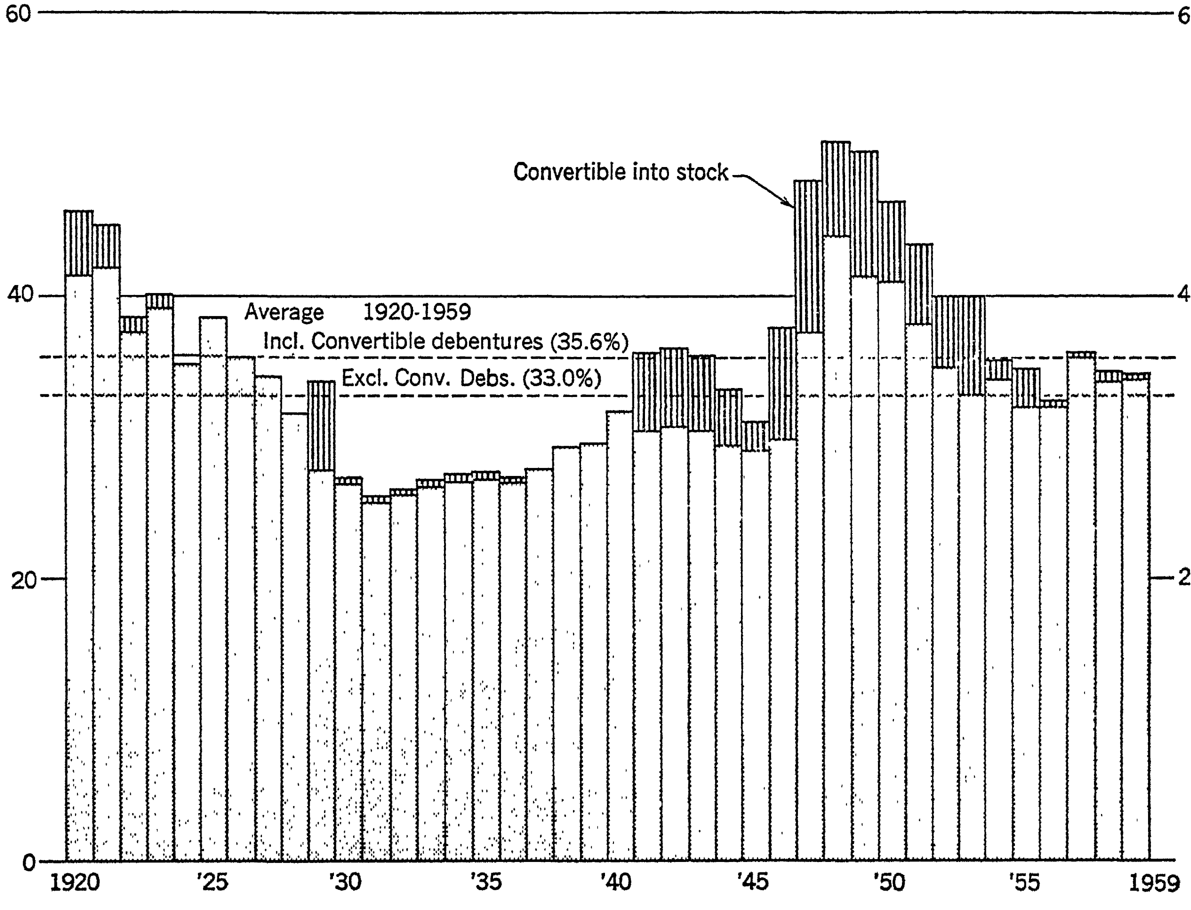
To show how a reverse of this procedure might cause confusion and lead to erroneous results, just consider the cost question alone which is fully explained in Chapter X. Debt might cost 4%, which would be equivalent to 2% after an income tax rate of 50%. Preferred stock might cost 5% and common 10%, with neither having any tax advantage.

We shouldn't say that preferred costs more than twice the net cost of debt after taxes, therefore don't use it but consider debt instead; this is incorrect reasoning. The two securities are quite unlike. At this point, we already should have settled the debt question on the basis of all of the factors to weigh in determining the use of debt.

Now that we are at the preferred stock stage, we should compare it with common, since it is a form of equity and more nearly like common than debt. We should say that preferred stock might cost one-half of common—provided it can be appropriately included. The cost rate for the preferred, which is based on the dividend rate, is much less than the common cost, which is based on the expected earnings per share of common. The question of whether preferred is appropriate requires an answer to the question: Will it detract from the quality of the common in the long run?

Let us take two examples. In order to have a sound credit standing and in order to maintain an adequate borrowing reserve, the management of American Telephone and Telegraph Company feels that their long term goal for the consolidated capital structure should be ⅓ debt and ⅔ common equity. Because of the nature of the telephone business, a *Double A* rating requires no more than about ⅓ debt. The system has a few relatively small issues of preferred stocks of subsidiaries, but these were sold many years ago and preferred has not been used in recent years. The management has not felt that preferred stock should be included. One of the apparent reasons for this policy is the fact that the system needs a large borrowing reserve, and when it is resorted to, the common would be pushed too far out on the limb. This can be seen from the chart above.

American Telephone and Telegraph Company and Subsidiaries
Debt Ratio to Total Capital Structure



After World War II, the system required tremendous amounts of capital to take care of expansion. Its earnings were inadequate and it could not sell common stock directly. The system had to rely temporarily on debt financing in one form or another. Debt was pushed up from about 30% in 1945 to over 50% of total capital structure by 1948. The company's bonds continued to be rated *Double A* throughout the entire period, because debt can get out of line temporarily without hurting the rating, provided the company has plans to return to its long-range goal when conditions permit. This is so because ratings are based on long-range averages. Since then, the debt level has again been restored to about ⅓ of total capital structure, principally through the sale of equity and conversion of convertible dedentures.

As the second example, consider the electric utility industry. Electric operating companies have generally followed a policy of including up to 15% of total capital structure in preferred stock on top of debt. For some actual figures, refer to page 12, where the capital structures of three electric companies are shown. The use of preferred has been possible because of the more stable nature of the power business and because of its more attractive characteristics. Past performance has indicated that with *Triple A* or *Double A* debt, as much as 15% preferred can be used without appreciably lowering the quality of the common stocks. Companies of that character have been able to finance large construction programs, use borrowing reserve when needed, and still maintain their common stocks at high quality.

Whether an industrial company should use a sliver of preferred ahead of the common, and if so, how much, becomes a question of carefully examining all the company's surrounding circumstances, after the debt ratio question has been decided. There is such great variation between industrial companies that it would be foolish to try to generalize.

Does the amount of debt affect the amount of preferred that can be issued? While the two securities are different in nature and affect capital structure differently, they cannot be considered entirely separately. Obviously, the more debt there is, the less preferred can be issued without pushing the common stock farther out on the limb, depending, of course, upon all the circumstances surrounding a company.

While it is improper to compare preferred with debt in deciding on its use, the yields on preferred stocks do tend to vary with interest rates, because they are both fixed or limited income types of securities. Therefore, it is interesting to note the spread between them and comparable bond yields.

Given below are Moody's average yields on three grades of outstanding issues of preferred stocks of industrial companies. There is also included the *Aaa* average of yields for outstanding bonds, as well as the spread between the yield of this average and that of high grade preferreds.

| | *Bonds Aaa Grade* | *Difference in Yield in Aaa Bonds and High Grade Preferreds* | *Preferreds* | | |
|---|---|---|---|---|---|
| | | | *10 High Grade*[1] | *10 Medium Grade*[1] | *10 Speculative Grade*[2] |
| 1959 | 4.27% | 0.18% | 4.45% | 4.80% | 5.58% |
| 1958 | 3.61 | 0.63 | 4.24 | 4.70 | 5.77 |
| 1957 | 3.76 | 0.60 | 4.36 | 4.89 | 5.91 |
| 1956 | 3.30 | 0.60 | 3.90 | 4.37 | 5.39 |
| 1955 | 3.00 | 0.69 | 3.69 | 4.09 | 5.14 |
| 1954 | 2.82 | 0.87 | 3.69 | 4.11 | 5.40 |
| 1953 | 3.12 | 0.76 | 3.88 | 4.24 | 5.74 |
| 1952 | 2.88 | 0.87 | 3.75 | 4.01 | 5.53 |
| 1951 | 2.78 | 0.93 | 3.71 | 3.99 | 5.42 |
| 1950 | 2.55 | 0.97 | 3.52 | 3.85 | 5.45 |
| *Average* | | 0.71 | | | |

[1] Low Dividend Series
[2] High Dividend Series

The spread in yields between various grades of preferred stocks tends to widen as the quality decreases just as for bonds. Note the variation in spread between the *Aaa* bond yields and high grade preferred yields. There has been a rule of thumb that, on the average, a good grade preferred stock should yield about 0.75% more than a bond of equal quality in order to compensate for its more junior position. In recent years this spread has narrowed.

The yields above are for outstanding issues and do not represent the cost of a new issue of preferred stock, which is generally higher.

This will be explained when we get to Chapter VII, "Selling Senior Securities."

If a company's characteristics are such that it can use both debt and preferred, then it is wise to do so. It makes for greater flexibility in financing by permitting a company to draw on different pools of capital. For example, if common can't be sold in a particular market, then there may be some investors willing to buy preferred. However, if flexibility in financing is to be one of the advantages of a capital structure, then preferred as well as debt must be kept within satisfactory limits so that leeway will exist when adverse conditions are encountered.

## SUMMARY OF CAPITAL STRUCTURE OF 125 INDUSTRIAL COMPANIES

Now look at some company figures. For this purpose we will refer to the 125 companies included in Moody's Industrial Common Stock Average. They are shown individually in the exhibit at the end of this chapter. The companies are grouped by type of industry. Where there is debt and no rating it generally means that the issue is held privately and not rated. The figures are as shown by Moody's Investor's Service, and are averages for a representative recent five-year period, the years 1955-59. They include capital structures and earnings protection for senior securities. The bond ratings are those of Moody's. Convertible preferreds are included with straight preferreds, and convertible debt issues with straight debt securities.

As previously stated, no consideration thus far has been given to the question of the treatment of financing by means of leases used by some companies in one form or another. Actually, this is most important in evaluating capital structure and the figures discussed in this chapter should be viewed with this in mind. This will be discussed in Chapter V, "Types of Securities."

The average capital structure for all the companies in the average over the five-year period was 15% debt, 4% preferred stock, and 81% common equity. The average times fixed charges earned after taxes was 21; the average times charges and preferred dividends earned was 9.

The figures in the exhibit may be summarized in the tables which follow.

Classification by
Types of Securities in Capital Structures

| | *Number of Cos.* | | *% of Total* | |
|---|---|---|---|---|
| Common Only | 18 | | 14% | |
| Preferred and Common | 11 | | 9 | |
| | | 29 | | 23% |
| Debt and Common | 53 | | 42% | |
| Debt, Preferred and Common | 43 | | 35 | |
| | | 96 | | 77% |
| | | 125 | | 100% |

From this table it can be seen that about one quarter of the companies used no debt, relying on common alone or common and preferred. Preferreds were used by almost one half of the companies. For companies which used preferred stock, on the average the amount was in the neighborhood of 9% of the capital structure. However, if you will note individual companies shown in the exhibit, there is rather wide variation in some instances from this average.

The next table shows a classification of those companies which had debt outstanding, rated and not rated, and by ratings for those rated.

Classification of
Companies With Debt Rated and Not Rated

| | | *Number* | | *% of Rated* |
|---|---|---|---|---|
| Rated— | *Aaa* | 6 | | 12 |
| | *Aa* | 22 | | 43 |
| | *A* | 16 | | 31 |
| | *Baa* | 4 | | 8 |
| | *Ba* | 2 | | 4 |
| | *B* | 1 | | 2 |
| | | | 51 | 100% |
| Not Rated—Mostly Held Privately | | | 45 | |
| Total | | | 96 | |

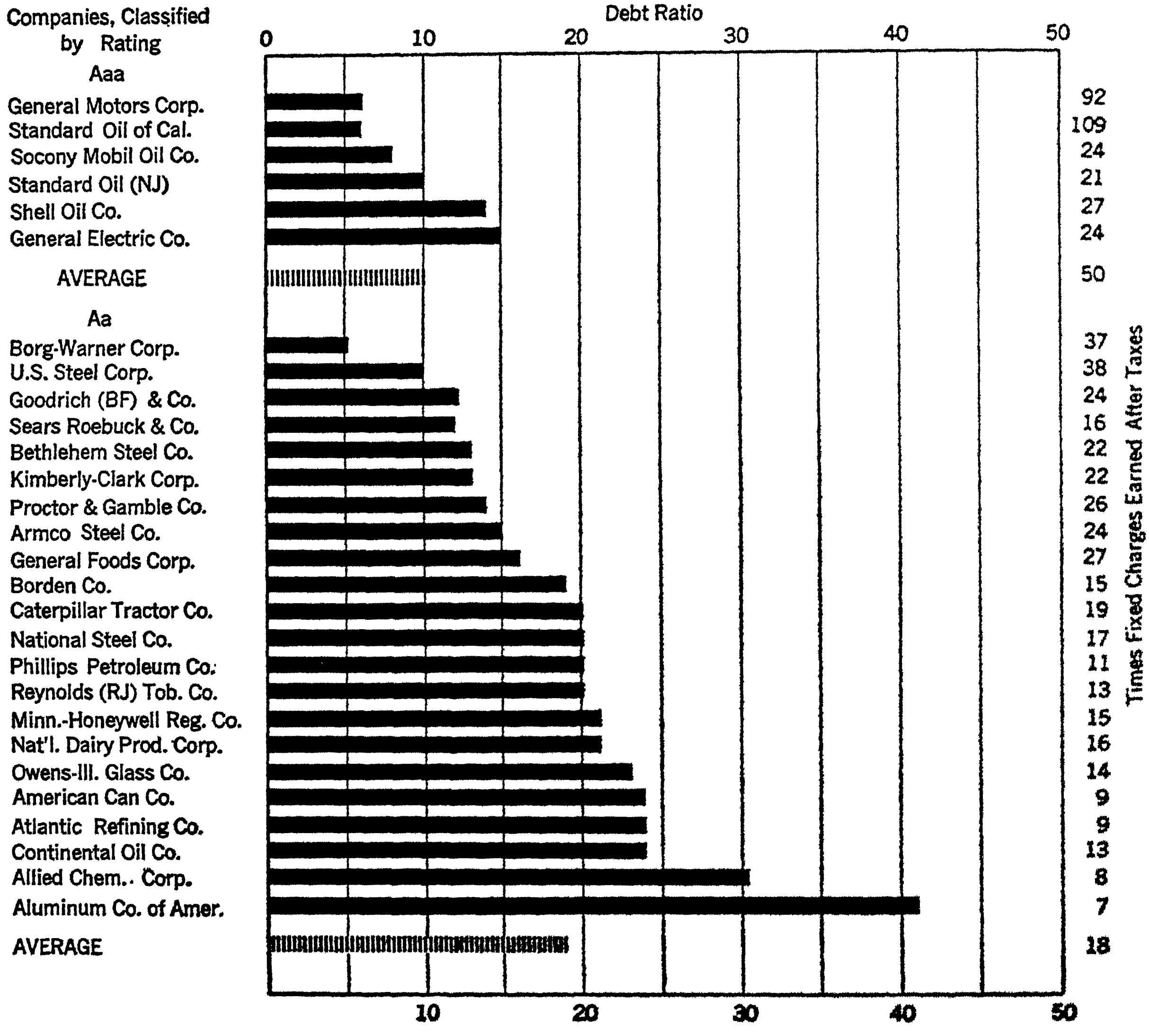
It can be seen that 55% of the companies which were rated had ratings of *Aaa* or *Aa* and that 86% were included in the *A* group or better.

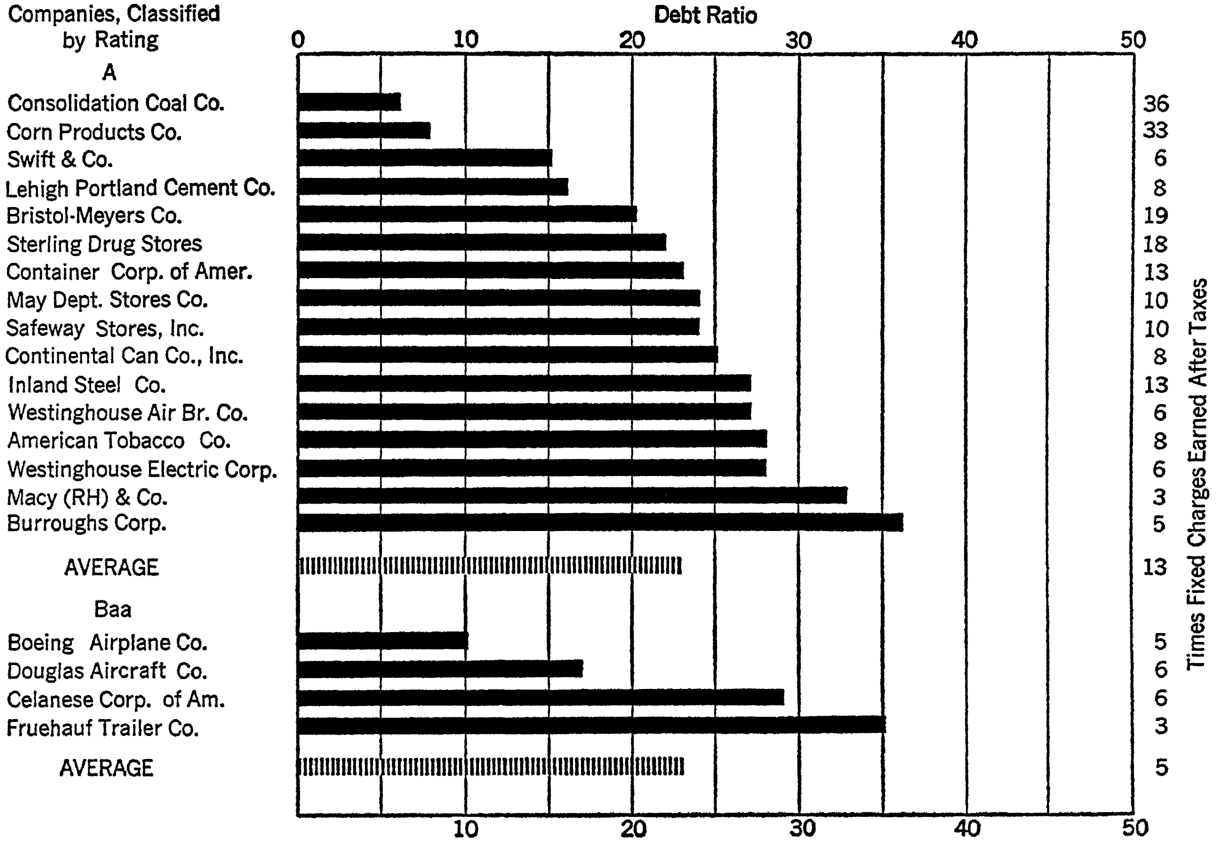
| | *Number of Companies* |
|---|---|
| Rating same by all three agencies | 25 |
| Fitch and Standard both one rating higher | 3 |
| Fitch and Standard both one rating lower | 0 |
| Fitch one rating higher | 3 |
| Fitch one rating lower | 5 |
| Standard one rating higher | 5 |
| Standard one rating lower | 5 |
| Not rated by Fitch and Standard | 2 |
| | 48 |

Of course, in considering the rating of a company's debt, you will wish to pay equal attention to the other agencies. It may be of interest to note how they compare with those of Moody's for the 48 companies which were rated *Baa* or higher by Moody's. Where a difference existed, there was no more than one rating difference by any of the agencies. This comparison is summarized on the left:

In the table with the bar chart which follows, there are shown the companies which were rated, classified by ratings, with their debt ratios and coverages. Other things being

Debt Ratio as a Per Cent of Capital Structure and Fixed Charges Earned After Taxes For companies in Moody's Industrial Common Stock Average with Rated Debt Averages 1955-1959 (In Order of Debt Ratios by Ratings)





equal, as debt goes up ratings go down. However, because other things are not equal between companies of different characteristics, there is wide variation in debt ratios for the same rating, particularly for industrial companies. This is quite apparent from the figures themselves. The same situation exists with regard to times-fixed-charges-earned.

## REVIEW OF CAPITAL STRUCTURE DETERMINATION

We might finish this Chapter with a few points in review:

1. Above all, the test of financial policy should be made over the long run. Careful weight should be given to the effect of bad times as well as good, particularly bad times, as outlined in the Four Long-Run *X*-Factors. These circumstances are the real test of financial strength; a company must be able to meet a debt maturity and to raise a large amount of capital at the same time.

2. Permanent debt may have an appropriate place in a capital structure depending on the nature of the company. However, it should not be used in excess so as to destroy borrowing reserve, or eliminate financial insurance, or weaken the common to such an extent as to increase the Cost-of-Capital. As a rule of thumb, it would seem appropriate for a large company to have as a goal that amount of debt which will permit it to be highly rated. That seems to best fit all the Six Determinants.

3. Those industrial companies which follow a policy of 100% equity have a built in reserve of strength. This cannot be overlooked as an advantage in this highly competitive world wherein companies may quickly find themselves in trouble, and may then need to resort temporarily to borrowing.

4. Preferred stock may have an appropriate place in capital structure provided it will not weaken the common during times of stress.

5. Small companies can't use ratings as a

direct guide. Under certain conditions, privately-owned companies are free to pursue a more flexible policy.

6. The final decision as to an appropriate type of capital structure can be made only after giving careful consideration to all the factors affecting a company and the industry in which it operates, and after applying many tests to determine the possible effect of different types of securities. Within the entire corporate field the range is wide. It is a matter of judgment, not mathematics, judgment arrived at by great foresight and yet sufficiently humble to appreciate that no one can foretell what will happen to a company except for a very limited number of years in the future.

### EXHIBIT

CAPITAL STRUCTURES AND EARNINGS COVERAGE FOR SENIOR SECURITIES
FOR 125 INDUSTRIAL COMPANIES
INCLUDED IN MOODY'S INDUSTRIAL COMMON STOCK AVERAGE

Grouped According to Moody's Industry Classification
Five-Year Average, 1955–59
(Exhibit prepared by Bohdan J. Kekish)

| *Companies, Classified by Industry* | *Rating* | *Capital Structure (% of total)* | | | *Times Fixed Chgs. Earned After Taxes* | *Times Fixed Chgs. & Pref. Div. Earned* |
|---|---|---|---|---|---|---|
| | | *Debt* | *Pref.* | *Com.* | | |
| *AGRICULTURAL IMPLEMENTS* | | | | | | |
| Allis-Chalmers Mfg. Co. | — | 23 | 3 | 74 | 6 | 5 |
| International Harvester Co. | — | 12 | 9 | 79 | 16 | 6 |
| *AIR CONDITIONING* | | | | | | |
| Borg-Warner Corp. | *Aa* | 5 | 5 | 90 | 37 | 23 |
| Carrier Corp. | — | 30 | 10 | 60 | 5 | 4 |
| *AUTOMOBILES* | | | | | | |
| Chrysler Corp. | — | 24 | 0 | 76 | 10 | — |
| Ford Motor Co. | — | 6 | 0 | 94 | 34[1] | — |
| General Motors Corp. | *Aaa* | 6 | 6 | 88 | 92 | 39 |
| Mack Trucks, Inc. | *Ba* | 27 | 1[9] | 72 | 4[1] | — |
| *AUTOMOBILE PARTS* | | | | | | |
| Electric Auto-Lite Co. | — | 21 | 0 | 79 | 12 | — |
| Electric Storage Battery Co. | — | 2 | 0 | 98 | 21[1] | — |
| Fruehauf Trailer Co. | *Baa* | 35 | 5 | 60 | 3 | 3 |
| Timken Roller Bearing Co. | — | 0 | 0 | 100 | — | — |
| *AVIATION* | | | | | | |
| Boeing Airplane Co. | *Baa* | 10[1] | 0 | 90 | 5[1] | — |
| Douglas Aircraft Co., Inc. | *Baa* | 17 | 0 | 83 | 6[1] | — |
| North American Aviation, Inc. | — | 0 | 0 | 100 | — | — |
| United Aircraft Corp. | — | 0 | 15 | 85 | — | — |
| *BUILDING MATERIALS & EQUIPMENT* | | | | | | |
| Am. Rad. & SS Corp. | — | 3 | 2 | 95 | 38[1] | 20[1] |
| Johns-Manville Corp. | — | 2 | 0 | 98 | 235 | — |
| Otis Elevator Co. | — | 0 | 0 | 100 | — | — |
| U. S. Gypsum Co. | — | 0 | 3 | 97 | — | — |
| *CAN MFG.* | | | | | | |
| American Can Co. | *Aa* | 24 | 8 | 68 | 9 | 5 |
| Continental Can Co., Inc. | *A* | 25 | 6 | 69 | 8 | 7 |
| *CEMENT* | | | | | | |
| Lehigh Portland Cement Co. | *A* | 16 | 0 | 84 | 8 | — |
| Lone Star Cement Corp. | — | 17 | 0 | 83 | 15 | — |

| *Companies, Classified by Industry* | *Rating* | *Capital Structure (% of total)* | | | *Times Fixed Chgs. Earned After Taxes* | *Times Fixed Chgs. & Pref. Div. Earned* |
|---|---|---|---|---|---|---|
| | | *Debt* | *Pref.* | *Com.* | | |
| *CHEMICALS* | | | | | | |
| Air Reduction Co., Inc. | — | 23 | 3 | 74 | 15 | 11 |
| Allied Chemical Corp. | *Aa* | 30 | 0 | 70 | 8 | — |
| Columbian Carbon Corp. | — | 15 | 0 | 85 | 12 | — |
| DuPont (E. I.) de N. & Co. | — | 0 | 10 | 90 | — | — |
| Eastman Kodak Co. | — | 0 | 1 | 99 | — | — |
| Monsanto Chemical Co. | — | 28 | 0 | 72 | 8 | — |
| Union Carbide Corp. | — | 34 | 0 | 66 | 10 | — |
| *COAL & COKE* | | | | | | |
| Consolidation Coal Co. | *A* | 6 | 0 | 94 | 36 | — |
| *DRUGS—MEDICINES—COSMETICS* | | | | | | |
| Bristol-Myers Co. | *A* | 20 | 10 | 70 | 19 | 13 |
| Parke, Davis & Co. | — | 0 | 0 | 100 | — | — |
| Sterling Drug, Inc. | *A* | 22 | 0 | 78 | 18 | — |
| *ELECTRICAL EQUIPMENT* | | | | | | |
| General Electric Co. | *Aaa* | 15 | 0 | 85 | 24 | — |
| Minn. Honeywell Reg. Co. | *Aa* | 21 | 3[10] | 76 | 15 | — |
| Westinghouse Electric Corp. | *A* | 28 | 4 | 68 | 6 | 5 |
| *ELECTRONICS* | | | | | | |
| Bendix Corp. | — | 0 | 0 | 100 | — | — |
| Texas Instruments, Inc. | — | 19 | 0[2] | 81 | 17 | —[2] |
| *FOOD* | | | | | | |
| Borden Co. | *Aa* | 19 | 0 | 81 | 15 | — |
| Coca-Cola Co. | — | 0 | 0 | 100 | — | — |
| Corn Products Co. | *A* | 7 | 8[3] | 85 | 33 | — |
| General Foods Corp. | *Aa* | 16 | 2[10] | 82 | 27 | — |
| General Mills, Inc. | — | 16 | 14 | 70 | 12 | 6 |
| National Biscuit Co. | — | 0 | 14 | 86 | — | — |
| Nat'l Dairy Prod. Corp. | *Aa* | 21 | 0 | 79 | 16 | — |
| Swift & Co. | *A* | 15 | 0 | 85 | 6 | — |
| United Fruit Co. | — | 0 | 0 | 100 | — | — |
| Wrigley (Wm.) Jr. Co. | — | 0 | 0 | 100 | — | — |
| *GLASS & GLASSWARE* | | | | | | |
| Libby-Owens-Ford Glass Co. | — | 0 | 0 | 100 | — | — |
| Owens-Illinois Glass Co. | *Aa* | 23 | 18[1] | 59 | 14 | 6[1] |
| *MACHINERY, EQUIPMENT & TOOLS* | | | | | | |
| Blaw-Knox Co. | — | 27 | 0 | 73 | 8 | — |
| Caterpillar Tractor Co. | *Aa* | 20 | 6 | 74 | 19 | 13 |
| Cincinnati Milling Mach. Co. | — | 0 | 7 | 93 | — | — |
| Clark Equipment Co. | — | 31 | 1[3] | 68 | 8 | — |
| Ingersoll-Rand Co. | — | 0 | 2 | 98 | — | — |
| Link-Belt Co. | — | 0 | 0 | 100 | — | — |
| *MINING & PROCESSING* | | | | | | |
| Aluminum Co. of America | *Aa* | 36 | 7 | 57 | 7 | 6 |
| Am. Smelting & Ref. Co. | — | 0 | 15 | 85 | — | — |
| Anaconda Co. | — | 11 | 0 | 89 | 15 | — |
| Internat'l Nkl. of Can. | — | 0 | 3[4] | 97 | — | — |
| Kennecott Copper Corp. | — | 0[5] | 0 | 100 | — | — |
| Phelps Dodge Corp. | — | 0 | 0 | 100 | — | — |
| St. Joseph Lead Co. | — | 12[1] | 0 | 88 | 28[1] | — |
| *MOTION PICTURES* | | | | | | |
| Paramount Pictures Corp. | — | 22 | 0 | 78 | 11 | — |

| *Companies, Classified by Industry* | *Rating* | *Capital Structure (% of total)* | | | *Times Fixed Chgs. Earned After Taxes* | *Times Fixe Chgs. & Pr Div. Earn* |
|---|---|---|---|---|---|---|
| | | *Debt* | *Pref.* | *Com.* | | |
| *OFFICE EQUIPMENT* | | | | | | |
| Burroughs Corp. | *A* | 36 | 0 | 64 | 5 | — |
| Internat'l Bus. Mach. Corp. | — | 42 | 0 | 58 | 9 | — |
| Nat'l Cash Reg. Co. | — | 33 | 0 | 67 | 8 | — |
| Underwood Corp. | — | 42 | 0 | 58 | 1[6] | — |
| *PAPER & PULP* | | | | | | |
| Container Corp. of Am. | *A* | 23 | 5 | 72 | 13[1] | 11[1] |
| Crown-Zellerback Corp. | — | 20 | 7 | 73 | 16 | 11 |
| Internat'l Paper Co. | — | 0 | 3 | 97 | — | — |
| Kimberly-Clark Corp. | *Aa* | 13 | 0 | 87 | 22 | — |
| Union Bag-Camp Paper Corp. | — | 10 | 0 | 90 | 246 | — |
| *PETROLEUM PRODUCING, REFINING, TRANSPORTING & DISTRIBUTING* | | | | | | |
| Atlantic Refining Co. | *Aa* | 24 | 6 | 70 | 9 | 7 |
| Continental Oil Co. | *Aa* | 24 | 0 | 76 | 13 | — |
| Ohio Oil Co. | — | 0[5] | 0 | 100 | — | — |
| Phillips Petroleum Co. | *Aa* | 20 | 0 | 80 | 11 | — |
| Shell Oil Co. | *Aaa* | 14 | 0 | 86 | 27 | — |
| Sinclair Oil Corp. | — | 26 | 0 | 74 | 7 | — |
| Socony Mobil Oil Co. | *Aaa* | 8 | 0 | 92 | 24 | — |
| Standard Oil Co. of Cal. | *Aaa* | 6 | 0 | 94 | 109 | — |
| Standard Oil (N. J.) | *Aaa* | 10 | 0 | 90 | 21 | — |
| *PUBLISHING—MAGAZINES* | | | | | | |
| Curtis Publishing Co. | *B* | 20 | 29 | 51 | 6[1] | 2[1] |
| *RADIO, TV & PHONOGRAPHS* | | | | | | |
| Philco Corp. | — | 21 | 8 | 71 | 20 | 8 |
| Radio Corporation of Am. | — | 46 | 3 | 51 | 6 | 4 |
| *RAILWAY EQUIPMENT* | | | | | | |
| ACF Industries, Inc. | — | 7 | 5[4] | 88 | 7 | — |
| Pullman, Inc. | — | 0 | 0 | 100 | — | — |
| Westinghouse Air Brake Co. | *A* | 27 | 0 | 73 | 6 | — |
| *REFRACTORY PRODUCTS* | | | | | | |
| Harbison-Walker Refr. Co. | — | 10 | 4 | 86 | 36 | 22 |
| *RETAIL STORES* | | | | | | |
| Kresge (S. S.) Co. | — | 10 | 0 | 90 | 19 | — |
| Kress (S. H.) & Co. | — | 1[7] | 0 | 99 | — | — |
| Macy (R. H.) & Co. | *A* | 33 | 18 | 49 | 3 | 2 |
| Marshall Field & Co. | — | 23 | 9 | 68 | 8 | 5 |
| May Dept. Stores Co. | *A* | 24 | 12 | 64 | 10 | 7 |
| Montgomery Ward & Co. Inc. | — | 0 | 3 | 97 | — | — |
| Penney (J. C.) Co. | — | 0 | 0 | 100 | — | — |
| Sears, Roebuck & Co. | *Aa* | 12 | 0 | 88 | 16[1] | — |
| Woolworth (F. W.) Co. | — | 24 | 0 | 76 | 10 | — |
| *RETAIL STORES—GROCERY* | | | | | | |
| American Stores, Inc. | — | 20 | 0 | 80 | 14 | — |
| Kroger Co. | — | 23 | 0[5] | 77 | 14 | — |
| Safeway Stores, Inc. | *A* | 24 | 14 | 62 | 10 | 7 |
| *SHOES—MANUFACTURING* | | | | | | |
| International Shoe Co. | — | 29 | 0 | 71 | 6 | — |
| *SOAPS & CLEANERS* | | | | | | |
| Colgate-Palmolive Co. | — | 17 | 6 | 77 | 10 | 8 |
| Procter & Gamble Co. | *Aa* | 14 | 0[6] | 86 | 26 | 24 |

| *Companies, Classified by Industry* | *Rating* | *Capital Structure (% of total)* | | | *Times Fixed Chgs. Earned After Taxes* | *Times Fixed Chgs. & Pref. Div. Earned* |
|---|---|---|---|---|---|---|
| | | *Debt* | *Pref.* | *Com.* | | |
| *STEEL & IRON* | | | | | | |
| Armco Steel Co. | *Aa* | 15 | 0 | 85 | 24 | — |
| Bethlehem Steel Corp. | *Aa* | 13 | 6 | 81 | 22 | 12 |
| Inland Steel Co. | *A* | 27 | 0 | 73 | 13 | — |
| National Steel Corp. | *Aa* | 20 | 0 | 80 | 17 | — |
| U. S. Steel Corp. | *Aa* | 10 | 11 | 79 | 38 | 10 |
| Youngstown Sheet & Tube Co. | — | 20 | 0 | 80 | 11 | — |
| *SUGAR REFINING* | | | | | | |
| American Sugar Ref. Co. | — | 4[8] | 32 | 64 | 22[1] | 3[1] |
| *SULPHUR* | | | | | | |
| Texas Gulf Sulphur Co. | — | 0 | 0 | 100 | — | — |
| *TEXTILES* | | | | | | |
| American Viscose Corp. | — | 0 | 0 | 100 | — | — |
| Burlington Industries, Inc. | — | 35 | 9 | 56 | 4 | 3 |
| Cannon Mills Co. | — | 0 | 0 | 100 | — | — |
| Celanese Corp. of Am. | *Baa* | 29 | 32 | 39 | 6 | 3 |
| Stevens (J. P.) & Co., Inc. | — | 19 | 0 | 81 | 5 | — |
| *TIRES, RUBBER & RUBBER GOODS* | | | | | | |
| General Tire & Rubber Co. | *Ba* | 33 | 16 | 51 | 5 | 4 |
| Goodrich (B. F.) Co. | *Aa* | 12 | 0 | 88 | 24 | — |
| Goodyear Tire & Rubber Co. | — | 34 | 0 | 66 | 8 | — |
| *TOBACCO PRODUCTS* | | | | | | |
| American Tobacco Co. | *A* | 28 | 8 | 64 | 8 | 6 |
| Liggett & Myers Tob. Co. | — | 26 | 6 | 68 | 8 | 6 |
| Reynolds (R. J.) Tob. Co. | *Aa* | 20 | 12 | 68 | 13 | 9 |
| Average for all Companies | | 15 | 4 | 81 | 21[11] | 9[12] |

Included in this exhibit are the 125 companies in Moody's Industrial Stock Average at the end of 1959.

Source of basic data: *Moody's Industrial Manual, 1960.*

Moody's includes some companies in more than one industry classification. In this exhibit they are shown in only one classification.

Ratings are those of Moody's Investors Service. Ratings on convertible issues are excluded.

Debt and preferred include convertible for each type. Debt includes mortgage bonds, debentures and loans due in more than one year. No allowance is made for lease financing, which may be an important factor affecting the capital structure. Included in common equity is common capital stock, surplus, and premiums on preferred and capital stock.

Moody's gives figures for times-fixed-charges-earned before and after taxes. The exhibit shows the figures after taxes. In computing times-fixed-charges-earned after taxes, the income is after deducting all federal and state income taxes and miscellaneous deductions. The fixed charges include interest on long-term debt; other interest charges; amortization of debt discount, premium, expense (net); taxes assumed on interest; interest charged to construction (cr.). Times-charges-and-preferred-dividends-earned is calculated similarly, except that preferred dividends are added to the fixed charges.

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[1] Based on data for less than five years.

[2] Preferred stock issued in 1959, represents 4.75% of the 1959 capital structure. Fixed charges and preferred dividend earned 19 times in 1959.

[3] Retired in 1958.

[4] Retired in 1957.

[5] Less than 1%.

[6] Fixed charges were not earned from 1956 through 1959.

[7] Debt contracted in 1959 represents 5.5% of the 1959 capital structure.

[8] Issued in 1958.

[9] Issued in 1959, represents 6.71% of the 1959 capital structure.

[10] Retired in 1956.

[11] Average based on data for companies with a reported debt in their capital structures.

[12] Average based on data for companies with a reported debt and preferred stock in their capital structures.

*CHAPTER III*

# Dividend Policy

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Suppose you were going to make a complete review of your entire financial policy and plan for the coming years, where would you start?

First, you would establish the basic structure of your financial policy by deciding on capital structure, covered in the last chapter. Next, you would need to obtain some figures on how much money your company would have to raise from the sale of long-term securities. This would be a result of your cash requirements for expansion and other purposes, and the amount of cash generated internally by earnings. Although these are not financial policy questions, one is involved because internal generation of cash is affected by dividend payments. Therefore, you would have to decide on dividend policy for your common stock as the second financial policy. This chapter gives you the reasoning to use and the principles to follow in formulating your policy.

There may be basic needs for cash which will limit dividend payments. Except for this limitation, the cash dividend is one of the few items in the budget almost entirely variable at the discretion of the management, or perhaps, it should be said, of the board of directors. As an aside, you might wonder why the qualification. Some managements when asked questions about dividend policy pass them off by replying: "Dividends are determined by the board of directors." That answer makes a poor impression on financial experts who know that the management must recommend the dividend policy to the board, and should have well-developed thoughts on such questions as type of dividend, percentage payout, and factors that management weighs in deciding on dividend policy. This is not to imply that management should pre-empt from the board the job of making dividend policy or that management should necessarily give out dividend forecasts. The latter subject is discussed subsequently in this chapter and in the one on investor relations.

Two major questions must be decided with regard to dividend policy: the type of cash payment, such as whether it is regular or irregular, etc., and the amount. They are to a degree interdependent; type will have an affect on the amount. Each is sufficiently complex to require separate treatment.

## PREMISES IN DETERMINING DIVIDEND POLICY

Before we start on the two questions, we should decide what we are trying to achieve and whom we are trying to satisfy; otherwise we will wander around rather aimlessly. What should be our premises?

What the common stockholders want and what is best for them over the long run should be paramount in our minds, since they own the company. Two thoughts are included here: what they want, and what is best for them. Both are qualified by the term "long run."

It is not what one individual stockholder wants, or a few; their interests may be opposite to those of the stockholders owning the majority of the stock. If some stockholders wish to sell their stock, they might desire an excessive increase in the dividend in order to obtain the cash before they sell, or in order to increase the market price temporarily. This might adversely affect the stock in the future, and be detrimental to those who continue to hold. When anyone sells stock, someone else buys, because for every seller there is a buyer. The company must have in mind what is good for the majority of stockholders over the long run.

At times, even the majority of stockholders may want the company to take immediate action which would be harmful over the long run. This raises a nice question of what the company should do if it considers the stockholders' wishes and carries out "true" corporate democracy. Here the job of the management is twofold: 1. Convince the stockholders that such a policy would be wrong. 2. Accept the fact that there is a turnover in the stockholder list, and that it has some obligation to follow sound policies for the continuing group of stockholders. With this in mind, management should resist unsound suggestions on the part of stockholders.

Management should not ignore any stockholder's communications, but it should beware of taking a few stockholders' letters as an indication of what the stockholders owning a majority of the stock want on such a subject as dividends. Those who write represent the opinion of the vocal stockholders. This opinion might be different from the majority. If the company should survey its stockholders on dividend policy, it should be cautious about the way the survey is made and interpreted. Many stockholders' immediate reaction would be to favor more cash. However, as will be explained subsequently, too high a payout may not do the best job over a long run. In any survey, an effort should be made to classify stockholders by appropriate questions, to distinguish between those who are knowledgeable about finance and those who know little about it. Furthermore, it would be advantageous to know which stockholders were taking a long and which a short range view. In order to assist in interpreting the survey, questions should be included such as: What type of policy do you prefer? What percentage of earnings should be paid out? How do you think that the type of payment affects payout? Are you primarily interested in appreciation or cash dividends? How do you think payout affects price? Such information is probably impossible to obtain. Certainly no survey should be attempted unless the management has thoroughly analyzed all aspects of the subject. In any event, management should have in mind how answers to such questions, as suggested above, might affect decisions on dividend policy.

In deciding on dividend policy, availability of funds for paying dividends may be an important factor. Three types of demands for funds which may have a more or less restrictive effect on payments, having in mind the benefit to stockholders, are as follows:

1. *Basic corporate needs.* By basic corporate needs are meant demands for cash which must be satisfied before dividends are paid. If a company is weak financially and it has some debt coming due which cannot be refinanced, it would wish to conserve cash in order to meet the payment. Furthermore, there is a minimum working capital position which should be maintained. As another example, certain types of creditors look askance at excessive dividend payments, which will weaken their position, especially when a company is not financially strong. Paying too much in dividends under such circumstances might hurt a company's ability to borrow. As an additional example, a company in poor financial condition might have to expand in order to save its old investment. To ignore such corporate needs would harm the stockholders rather than help them.

2. *Profitable expansion when outside capital can't be raised.* Aside from any problems of saving its old investment as discussed above, if a company has profitable expansion possibilities which it is unable to finance, a nice question is raised as to whether a company should ignore stockholders' wishes for dividends and conserve cash for such expansion. If it would improve the position of the existing common stockholders by more than offsetting any harm from limiting cash dividend payments, such a policy would be justified.

3. *Profitable expansion when outside capital can be raised satisfactorily.* The need for capital to expand should not weigh heavily in determining dividend policy if the company can finance on a satisfactory basis. Then the funds required for expansion which are not supplied by cash generated internally should be raised through the sale of securities. In this situation, dividend policy comes first, and should not be made dependent upon expansion requirements.

A management may contend that it should withhold earnings and thus obtain equity capital, rather than sell common stock[1] and incur financing costs. Of course, by retaining earnings, the company eliminates financing costs, but it is still more important first to consider dividend policy as far as the common stockholder is concerned. This can be explained by a simple example. Let's assume the following situation:

| | |
|---|---|
| Common equity | $100,000,000 |
| Number of shares | 1,000,000 |
| Rate earned on common equity | 10% |
| Earnings per share | $10.00 |
| Dividends per share (payout ratio 65%) | $6.50 |

After considering all factors, it is decided that the company needs equity money for expansion, which must be obtained from retained earnings or sale of common stock. It can obtain $3,500,000 from retained earnings without disturbing its dividend policy. It is considering the possibility of reducing the dividend to a 50% payout, or $5.00 per share, in order to obtain an additional $1,500,000 from retained earnings. By so doing, it would save[2] financing costs on that $1,500,000 as contrasted with raising it by the sale of common stock. Financing costs for sale of common stock are explained in Chapter VIII. For our present purpose, accept a figure for financing costs of 10% of the sale price of the stock, which would amount to $150,000 for $1,500,000 of new common stock. This sounds like a lot of money, but we are interested in its effect on the entire common stock. Financing costs reduce the net proceeds the company receives. This would mean that the company would have $150,000 less on which to produce a return; assuming a return of 10%, this would amount to only $15,000 annually. It would be negligible in terms of earnings per share. Another way to look at it is to assume that the company would have to sell additional shares to provide an additional $150,000 of capital to make up for the financing costs, and to this extent there would be a dilution in earnings per share. However, on the basis of the 1,000,000 total number of shares outstanding, it would still have a very minor effect on the earnings per share. On the other hand, a cut in the dividend from $6.50 per share to $5.00 might have a material adverse effect on the market price of the stock.

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[1] Another entirely different consideration is the benefit to existing stockholders when new stock is sold at a premium above the book value (based on a proper value of the assets) per share.

[2] As will be explained in Chapter X, a company should plan to earn a sufficient rate on all of its equity so that financing costs are recovered on retained earnings as well as on money raised from the sale of common.

It should be realized that this discussion has nothing to do with the merits of payout vs. plowback of earnings, as it may affect the price of a stock. This is discussed subsequently. The only purpose for the above figures is to show that dividend policy should not be affected by money required for expansion, provided a company has the ability to sell common stock at a reasonable price. In other words, under such circumstances dividend policy comes first.

Warning! If you do not expect to earn at least your Cost-of-Capital on new projects, you have no justification whatsoever for retaining earnings on the grounds that the company needs money for plant expansion. This will be apparent in Chapter X, "Profit Goals—Cost-of-Capital." While a strong cash position is good to maintain, a company should not hold huge amounts of cash just on the vague assumption that sometime, somehow, it might be handy to have. Such excess cash should be paid to stockholders to use as they see fit. This is not to suggest that a company which is expanding should not keep cash available for any reasonable prospect for expansion.

We have stressed that our key to dividend policy is what is best for the stockholders over the long run. What further tests can we use as a guide to carrying out this principle? The best answer can be found in what a stockholder gets from a common stock. Although already discussed in the first chapter, this topic deserves more elaboration here. There are just two things—dividends and appreciation in the market price of the stock. The common stockholder gets nothing else whatsoever. This would seem to de-emphasize the importance of earnings per share. Not at all. Throughout this book, the amount and quality of earnings per share will be stressed as the principal factor in evaluating the price of a common stock. As a matter of fact, it is only through earnings per share that dividends and appreciation of the market price of the stock can be achieved.

Stockholders' desires may differ as to which is more important—dividends or market price appreciation. Their needs for cash income as well as their tax bracket will affect their desires—cash dividends being taxed at the regular personal tax rates and market price appreciation after six months being taxed at the capital gains rate. The ultimate test of dividend policy is to be found in the effect on the price of the stock over the long run, because the price is a result of buying and selling by investors. The price, in one figure, sums up the varying desires of investors with regard to a particular stock. Therefore, we should have in mind that a principal test for dividend policy involves the question of which policy will produce the best market price for the stock over the long run. Of course, we will have to take into account any difference in cash payments, as well as the difference in market price, in comparing one policy with another.

An added factor justifying the highest market price approach for the outstanding stock, is the benefit to existing stockholders when the company sells new common stock, since the sale price is thereby enhanced. To the extent that it is enhanced, it will result in a larger book value per share after the financing.

The *type* of company, as it affects the company's prospects for stability of earnings, and its ability to earn will be important in deciding on what is the best dividend policy. These factors will influence the type of investors who are attracted to it. For example, a very speculative business with a large earnings potential would tend to attract wealthy investors. They could take the risk of such an enterprise and would wish to speculate on price appreciation rather than cash income because of their tax bracket. However, persons with lower income, who are more dependent on their income from investments, would tend to want cash income and seek a more stable type of company, as would tax-exempt institutional investors.

| | *1st Year by Quarters* | | | | *2nd Year by Quarters* | | | |
|---|---|---|---|---|---|---|---|---|
| | *1st* | *2nd* | *3rd* | *4th* | *1st* | *2nd* | *3rd* | *4th* |
| I. Regular | 10¢ | 10¢ | 10¢ | 10¢ | 10¢ | 10¢ | 10¢ | 10¢ |
| II. Regular Increasing Irregularly | 10¢ | 10¢ | 11¢ | 11¢ | 12¢ | 12¢ | 14¢ | 14¢ |
| III. Regular Increasing Regularly | 10¢ | 10¢ | 10¢ | 12¢ | 12¢ | 12¢ | 12¢ | 14¢ |
| IV. Regular with Irregular Extra | 10¢ | 10¢ | 10¢ | 10¢<br>4¢ extra | 10¢ | 10¢ | 10¢ | 10¢<br>2¢ extra |
| V. Regular with Regular Extra | 10¢ | 10¢ | 10¢ | 10¢<br>3¢ extra | 10¢ | 10¢ | 10¢ | 10¢<br>3¢ extra |
| VI. Variable | 10¢ | 5¢ | 5¢ | 12¢ | 10¢ | 14¢ | 10¢ | 5¢ |

Now we will consider the questions of type and amount of dividends in terms of the above premises. The problem is principally to decide what dividend policy will produce the best market price for the stock over the long run.

## TYPES OF CASH PAYMENTS

We will start off with types of payments, because they may affect the amount paid. The principal types of cash dividends as illustrated by quarterly payments per share without any specific regard to amount, are shown in the table above.

### *Stockholders' Desires As They Affect Type*

What does a stockholder want and what has he a right to expect with regard to these types? Above all, dividends should increase over a period of time. Why? Because a company practically never pays out all of its earnings in dividends. The retained portion of the earnings remains in the company and the stockholders' equity increases to the extent of such retained earnings. A company should earn on the added investment—which should result in increased earnings per share and eventually mean some dividend increase.

Certainty or regularity of income is also important to a stockholder; so if we combine these two features, then the most desirable type of dividend is *III, Regular Increasing Regularly*. If this is a company's dividend policy, the stockholder knows, as far as possible, what he can expect.

Our first type listed above—*Regular*—in itself is not satisfactory. It gives no benefit to the stockholders in the form of increased dividends which should result from the retained earnings.

The most celebrated regular dividend was that of the American Telephone and Telegraph Company which was paid at an annual rate of $9 from 1922 to 1959. The company has the largest number of stockholders of any corporation. The regularity of the $9 apparently has an appeal to that company's great body of stockholders. That rate was maintained for so long that the common stock is sometimes referred to as a preferred stock. This is erroneous, because a preferred stock must have some common equity behind it to give protection to the preferred. The preferred dividend must be well covered by earnings. For a good preferred stock in a relatively stable field, the over-all coverage of interest charges and preferred dividends should be over two times. If the A.T. and T. common dividends were looked upon as preferred dividends and the over-all coverage figured on a consolidated basis, the result would be far too low for a preferred stock. Obviously, the stock should not be classified in that category. Fortunately, the stockholders of A.T. and T. have received something more than the $9 dividend, in the form of valuable rights when new common stock or convertibles were offered to stockholders. The regular dividend was finally increased in 1959 after the stock was split.

The second dividend type—*Regular Increasing Irregularly*—is far superior to type I, *Regular*, because it recognizes the need for an increase. To the extent that the increase is irregular, it is not as ideal as *III*. From a practical point of view, it is probably much more possible to achieve *II* than *III*, which is too theoretical for many companies even to dream about.

Let's go to our next two types involving extras—*IV*, *Regular with Irregular Extra*, and *V*, *Regular with Regular Extra*. The irregular extra is not expected to be repeated. The regular extra is expected to be repeated if conditions warrant. The irregular extra can be used when a company has unusually good earnings and wishes to pass on the earnings to its stockholders. The market price of the company's stock will not be affected to any material extent by this type of extra. Thus, the stockholders will only be temporarily benefited. However, if, by increasing the regular dividend, a company is uncertain whether a higher rate can be maintained, it could start out with a regular extra but make it clear that it will be paid only if conditions warrant.

It can be correctly argued that the market will not give the same effect to a regular extra as it will to a similar regular dividend, due to the uncertainty involved. How much the market will discount the regular extra compared with a similar amount of regular will depend on the prospects of the extra being continued. The advantage of the regular extra lies in the fact that it may permit some companies to pay out a higher percentage, yet not be in the embarrassing position of having to tamper with its regular rate if adverse conditions develop. As an example of the use of the regular extra, here is how a company, which paid 75¢ quarterly with a 25¢ regular extra in the last quarter, explained the situation in its annual report: "It is our belief, based on careful estimates of our business for this year, that continuance of the 75-cent quarterly dividend on the common stock is justified and a dividend at that rate has already been declared for the first quarter. We are hopeful that earnings at the end of the year will again permit declaration of a year-end dividend."

If a company's earnings are relatively stable, the company should not appear overly timid and declare an extra which could justifiably be rolled into the regular rate. As stated above, the mere fact that part of the dividend is labeled extra takes away some of its appeal because of the connotation of uncertainty.

Now we come to the final category—*VI*, *Variable*. If a company is in a cyclical business and one which is quite risky, so that earnings per share are highly variable, then the company will have to declare dividends at variable rates as earnings materialize. The best that a company of this type might achieve, if its earnings were not too variable, would be a low regular dividend with extras adjusted to meet the variability of the situation.

### *Nature of Company As It Affects Type*

It has already been indicated that the extent to which a company is able to approach the ideal type of dividend—regular increasing regularly—will depend on the nature of the company itself. Since there are all shades of variability of earnings for different types of companies, there will be many shades of dividend policy.

To lead stockholders to believe that a company will maintain a regular dividend, and then to have to cut it, may create serious stockholder ill will. For example, a company in a relatively unstable business made statements akin to the following: "We have established a regular 50¢ quarterly dividend and will attempt to maintain that base dividend." As a result of this and other statements by the management, which were all made in complete sincerity and good faith, investors were led to believe that the 50¢ quarterly rate would be maintained, come what may. Unfortunately, the management had underestimated the variability of the earnings. Here is approximately what happened.

| | *Earnings per Share* | *Dividends per Share* | *% Payout* |
|---|---|---|---|
| The Year in Which the 50¢ Quarterly Dividend Set | $3.60 | $2.00 | 56% |
| Next Year | 4.00 | 2.25[1] | 56 |
| Two Years Following | 1.00 | 1.50 | 150 |

[1] Includes 25¢ extra.

When the dividend was cut, reaction of the stockholders was bad, although the management had acted in the best interest of the stockholders under the circumstances.

A final word about the term "regular." This does not mean that a company should not cut a regular dividend if special circumstances are encountered making that action wise. However, it should strain to continue the payments, even when not fully earned, if adverse earnings are expected to be only temporary. Dividend record has an important effect on the appeal of a company's common stock for investors and on its price.[3]

## DATES OF PAYMENTS AND FRACTIONAL PAYMENTS

At this point, we should say a word about frequency of payments. Most companies pay dividends quarterly. There are a few which pay them monthly, semiannually and annually. From the stockholders' point of view, income spread out quarterly would be preferable to payments semi-annually or annually. This is not a major issue, but if a company's dividend is sufficient in amount to appeal to stockholders, it would seem wise to adopt a quarterly dividend policy to meet their interests better. Dividend payments do require expense on the part of the company and any further refinement to payments monthly would not be sufficiently advantageous to justify the extra cost.

A company which has preferred stock outstanding may wish to have those payments on the same dates as the common so that the directors can declare both at the same time. This is not of major importance.

Payments in fractional cents are no obstacle. For a company which pays $2.25 annually, the quarterly rate is 56¼¢. One way to handle the fraction is to pay the total amount due each stockholder on the basis of the next highest cent. If calculation of the payments is done on machine, it is a simple matter to plug the machine for the fraction.

## AMOUNT OF PAYMENT[4]

The amount of payment may be expressed by the term payout, or payout ratio, although it is a percentage figure and not a ratio. It is obtained by dividing dividends per share actually paid in a year, by the earnings per share in that year and expressing the result as a percentage.

If a company has increased the regular quarterly rate in a year, security analysts may compute the payout as though the new rate had been in effect for the full year. This shows the burden of the new rate in terms of current earnings. Figured that way, it should be so labeled. A similar situation exists when new common stock has been recently issued. To dampen the effect of the new issue, while the money is being put to work, some analysts may calculate average earnings per share on the stock and figure a payout with those earnings.

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[3] Some state laws governing the investments of common stocks for certain institutions include dividend requirement provisions. For example, certain common stocks, to be eligible for investment by New York savings banks and insurance companies, must, among other things, have paid cash dividends on its common stock in each year for a period of ten years next preceding the date of investment.

[4] The Federal tax code (Internal Revenue Code, Section 531) penalizes any undue withholding of dividends under certain circumstances, but there is nothing in the discussion in this book that suggests evasion of this statute.

If you wanted to quiz someone on dividend payout and put him on the spot, your first question might be: "Why not pay out all earnings in dividends?" The person would probably be so startled at such a thought that he might not have a ready answer. It isn't easy to answer except in generalities.

One answer has already been suggested under the term *basic corporate needs*;[5] among the reasons given under that heading, lending institutions might not like to have a company dissipate its assets by paying out all its earnings in dividends. There are two other reasons: 1. There would be no earnings retained to build up the stockholders' investment and thus produce capital gains. 2. The last increment of the dividend would be so uncertain that it would have little benefit to the market price of stock. You may not fully understand the basis of this answer now, but it should become clear as we go about the problem of payout step by step.

| | 50% PAYOUT | | | 75% PAYOUT | | |
|---|---|---|---|---|---|---|
| *Year* | *Book Value per Share— Beginning of Year* | *Earnings per Share* | *Dividends per Share* | *Book Value per Share— Beginning of Year* | *Earnings per Share* | *Dividends per Share* |
| 1st | $100.00 | $10.00 | $ 5.00 | $100.00 | $10.00 | $ 7.50 |
| 2nd | 105.00 | 10.50 | 5.25 | 102.50 | 10.25 | 7.69 |
| 3rd | 110.25 | 11.03 | 5.52 | 105.06 | 10.51 | 7.88 |
| 4th | 115.76 | 11.58 | 5.79 | 107.69 | 10.77 | 8.08 |
| 5th | 121.55 | 12.16 | 6.08 | 110.38 | 11.04 | 8.28 |
| 6th | 127.63 | | | 113.14 | | |
| Total | | | $27.64 | | | $39.43 |

### *Type As It Affects Amount*

First, a word about type of dividend as it affects the amount of payout. If a company establishes a regular dividend, it should be set at a sufficiently conservative amount so that even under reasonably adverse conditions it can be maintained. If it is felt that more should be paid out, it can be done with extras. With a variable type of dividend, the type has less bearing on the amount paid, because as the earnings change in the future, so can the dividend be changed.

In deciding on amount of payout as related to type, a thorough analysis of past earnings and potential risks of changes in earnings must be made. One test to weigh is the dividend in relation to earnings resulting from an earnings rate on total capital that can be maintained with adverse conditions. To put it another way, what is the minimum rate that must be earned on total capital in order just to earn the regular dividend, and can that minimum rate be earned under adverse circumstances?

### *Payout* vs. *Plowback*

Our next consideration in payout is the effect it has on the building up of the stockholders' investment in book value through the proportion of earnings retained, also referred to as plowback. A simple example will illustrate the point. Company A earns 10% on its common equity. First, it pays out 50% of its earnings in dividends. Then the payout is increased to 75%. The figures over a five-year period would be as shown in table above.

The results at the end of five years are summarized in the following table.

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[5] *Supra*, p. 40.

| *Payout* | *Book Value per Share* | *Earnings per Share* | *Total Dividends Paid* |
|---|---|---|---|
| 50% | $127.63 | $12.16 | $27.64 |
| 75% | 113.14 | 11.04 | 39.43 |

You may wonder why the book value plus dividends paid is not equal for the two payouts. The total is higher for the lower payout because there is an added amount of retained earnings on which the 10% can be earned. If the added dividends for the higher payout were reinvested at a rate of 10%, the totals would be the same.

It may be well to point out that the increases in the book values are merely the compound interest effect of the rate of earnings allocated to plowback, which is 5% for the 50% payout and 2½% for the 75% payout.

This simple table brings out the idea that the person needing income likes the high payout, whereas the person seeking capital appreciation rather than cash income would prefer the lower payout so that his investment would grow. As a matter of fact, if we were concerned only with companies which are privately owned with no market for the common stock, we could stop right here. The owners would tell management how much of the earnings they wanted in dividends and how much plowed back on the basis of figures such as the above.

Even for a company which is publicly owned, it would be easy to decide on the amount of payout, provided you knew what your stockholders wanted. For publicly-owned companies, the fun now begins. First, by way of review, we should take the following steps to determine the amount of payout for a publicly-owned company:

1. Consider the desires of some stockholders for cash income, which favors high payout.

2. Consider the desires of some stockholders for capital appreciation rather than current cash income, which tends to suggest low payout.

3. Since any person seeking to realize on his investment can do so only through sale at the market price, our final test is to evaluate how dividend payout affects market price.

### *Market Price Effect*

As far as the market price is concerned, there is an apparent conflict in the amount of dividends per share that should be paid. While an increase in dividends may increase the market price, retained earnings build up common equity. This will increase future earnings per share if the company is able to earn adequately on those earnings retained. As previously stated, the factor of earnings per share, in general, has the most important effect on market price. So, we have what seems to be an almost insurmountable riddle of seeking a proper balance between two cross currents.

Now for the job of trying to resolve this riddle of the effect of dividend policy on the market price of the stock. We can make only some very broad assumptions and then see what happens. Since these assumptions will be extremes and for illustrative purposes only, it will be necessary for you to make a special study of your own situation. You will have the tools with which to work.

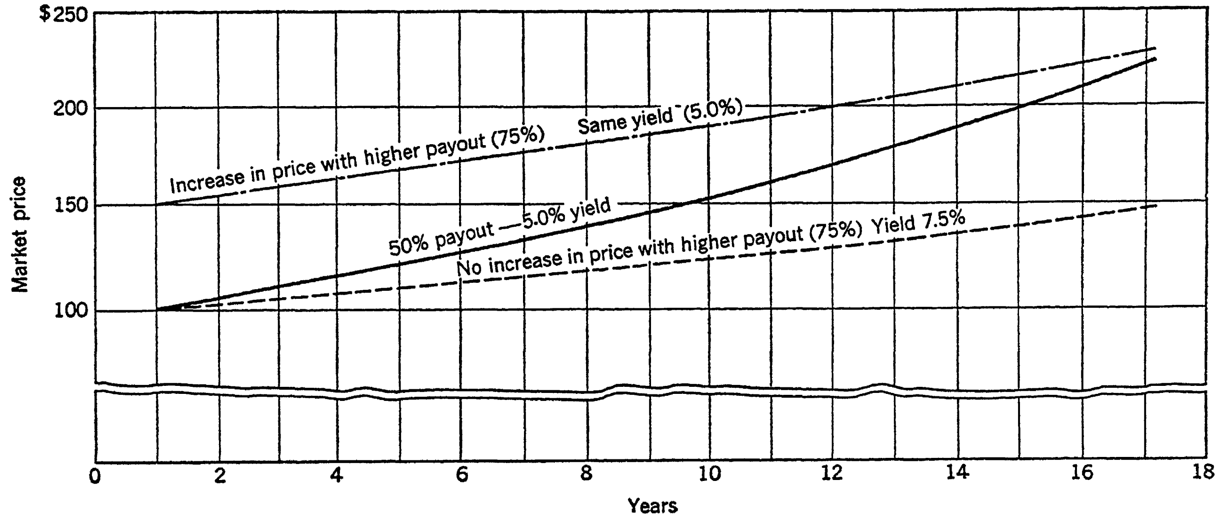
We will start out with the figures we previously used to show the effect of payout and plowback on dividends and book value. Our Company A earned 10% on its common equity and first paid out 50% of its earnings in dividends. In order to translate this in terms of market value, we will pretend that the stock sells in the market so that the yield is 5%. The figures are shown in the first four columns in the table on next page below the chart. Don't look at the chart yet.

In the last five columns are shown figures with payout increased to 75%. Here is where the big assumptions begin, regarding market price. We will consider two extremes:

1. Column VIII shows the market price if that price did not at all increase with the increase in dividend resulting from an increase in payout. In this situation, such an increase in

## COMPANY A

### Effect of Payout on Market Price
### 10% Earned on Book Value of Common



### Company A—10% Earned on Book Value of Common

| | 50% Payout | | | | 75% Payout | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Year* | *Book Value* I | *Earned per Share* II | *Dividends per Share* III | *Market Price with 5.0% Yield*[1] IV | *Book Value* V | *Earned per Share* VI | *Dividends per Share* VII | *Market Price with 7½% Yield*[1] VIII | *Market Price with 5.0% Yield*[2] IX |
| 1st | $100.00 | $10.00 | $ 5.00 | $100.00 | $100.00 | $10.00 | $ 7.50 | $100.00 | $150.00 |
| 2nd | 105.00 | 10.50 | 5.25 | 105.00 | 102.50 | 10.25 | 7.69 | 102.50 | 153.75 |
| 3rd | 110.25 | 11.03 | 5.52 | 110.30 | 105.06 | 10.51 | 7.88 | 105.10 | 157.65 |
| 4th | 115.76 | 11.58 | 5.79 | 115.80 | 107.69 | 10.77 | 8.08 | 107.70 | 161.55 |
| 5th | 121.55 | 12.16 | 6.08 | 121.60 | 110.38 | 11.04 | 8.28 | 110.40 | 165.60 |
| 6th | 127.63 | 12.76 | 6.38 | 127.60 | 113.14 | 11.31 | 8.48 | 113.10 | 169.65 |
| 7th | 134.01 | 13.40 | 6.70 | 134.00 | 115.97 | 11.60 | 8.70 | 116.00 | 174.00 |
| 8th | 140.71 | 14.07 | 7.04 | 140.70 | 118.87 | 11.89 | 8.92 | 118.90 | 178.35 |
| 9th | 147.74 | 14.77 | 7.39 | 147.70 | 121.84 | 12.18 | 9.14 | 121.80 | 182.70 |
| 10th | 155.12 | 15.51 | 7.76 | 155.10 | 124.88 | 12.49 | 9.37 | 124.90 | 187.35 |
| 11th | 162.87 | 16.29 | 8.15 | 162.90 | 128.00 | 12.80 | 9.60 | 128.00 | 192.00 |
| 12th | 171.01 | 17.10 | 8.55 | 171.00 | 131.20 | 13.12 | 9.84 | 131.20 | 196.80 |
| 13th | 179.56 | 17.96 | 8.98 | 179.60 | 134.48 | 13.45 | 10.09 | 134.50 | 201.75 |
| 14th | 188.54 | 18.85 | 9.43 | 188.50 | 137.84 | 13.78 | 10.34 | 137.80 | 206.70 |
| 15th | 197.96 | 19.80 | 9.90 | 198.00 | 141.28 | 14.13 | 10.60 | 141.30 | 211.95 |
| 16th | 207.86 | 20.79 | 10.40 | 207.90 | 144.81 | 14.48 | 10.86 | 144.80 | 217.20 |
| 17th | 218.25 | 21.83 | 10.92 | 218.30 | 148.43 | 14.84 | 11.13 | 148.40 | 222.60 |

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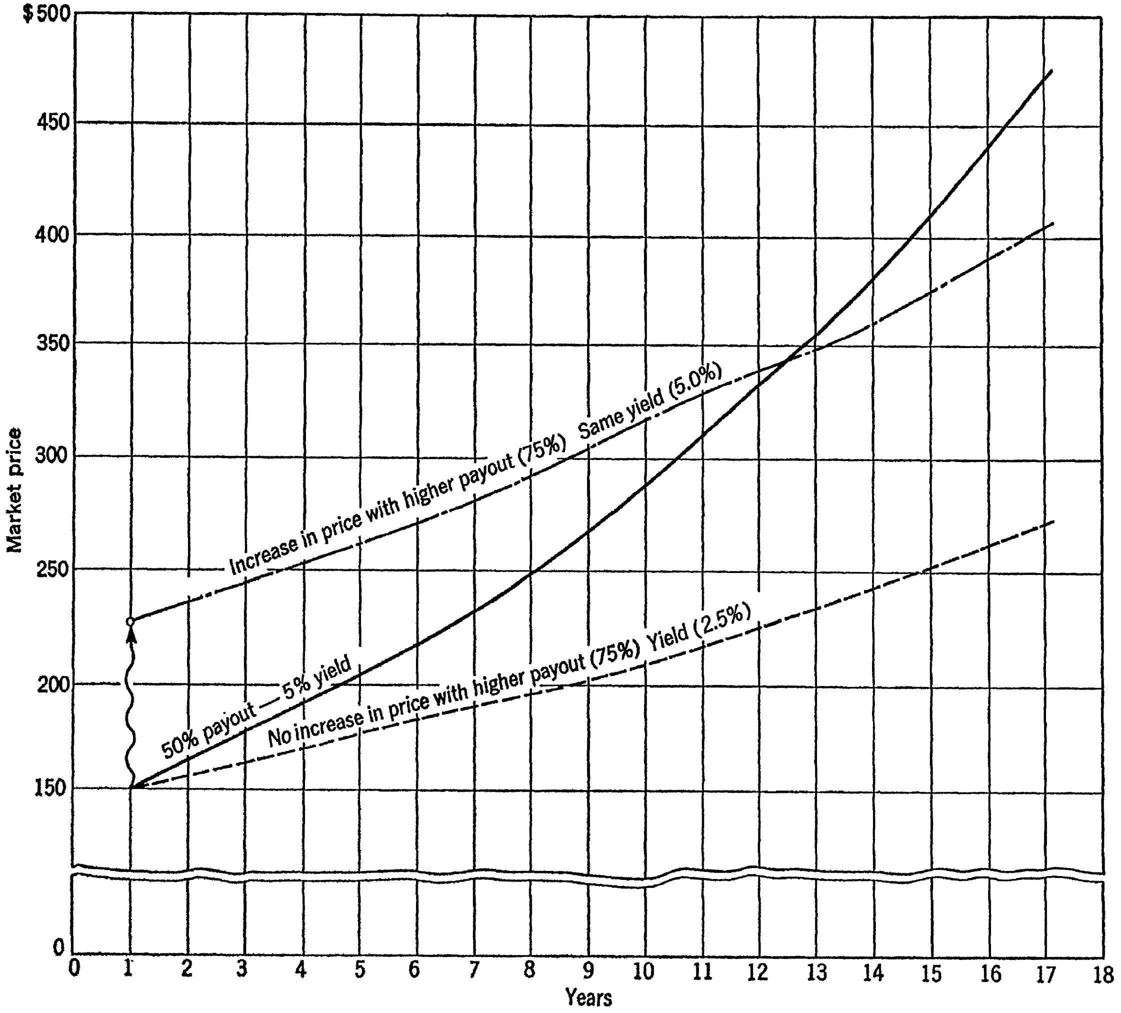
[1] Market Price represents 10 times earnings per share in each year.

[2] Market Price represents 15 times earnings per share in each year.

## COMPANY B

Effect of Payout on Market Price
15% Earned on Book Value of Common



### COMPANY B—15% EARNED ON BOOK VALUE

| | 50% PAYOUT | | | | 75% PAYOUT | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Year* | *Book Value* I | *Earned per Share* II | *Dividends per Share* III | *Market Price with 5.0% Yield*[1] IV | *Book Value* V | *Earned per Share* VI | *Dividends per Share* VII | *Market Price with 7½% Yield*[1] VIII | *Market Price with 5.0% Yield*[2] IX |
| 1 | $100.00 | $15.00 | $ 7.50 | $150.00 | $100.00 | $15.00 | $11.25 | $150.00 | $225.00 |
| 2 | 107.50 | 16.13 | 8.07 | 161.30 | 103.75 | 15.56 | 11.67 | 155.60 | 233.40 |
| 3 | 115.56 | 17.33 | 8.67 | 173.30 | 107.64 | 16.15 | 12.11 | 161.50 | 242.25 |
| 4 | 124.22 | 18.63 | 9.32 | 186.30 | 111.68 | 16.75 | 12.56 | 167.50 | 251.25 |
| 5 | 133.63 | 20.03 | 10.02 | 200.30 | 115.87 | 17.38 | 13.04 | 173.80 | 260.70 |
| 6 | 143.54 | 21.53 | 10.77 | 215.30 | 120.21 | 18.03 | 13.52 | 180.30 | 270.45 |
| 7 | 154.30 | 23.15 | 11.58 | 231.50 | 124.72 | 18.71 | 14.03 | 187.10 | 280.65 |
| 8 | 165.87 | 24.88 | 12.44 | 248.80 | 129.40 | 19.41 | 14.56 | 194.10 | 291.15 |
| 9 | 178.31 | 26.75 | 13.38 | 267.50 | 134.25 | 20.14 | 15.11 | 201.40 | 302.10 |
| 10 | 191.68 | 28.75 | 14.38 | 287.50 | 139.28 | 20.89 | 15.67 | 208.90 | 313.35 |
| 11 | 206.05 | 30.91 | 15.46 | 309.10 | 144.47 | 21.67 | 16.25 | 216.70 | 325.05 |
| 12 | 221.50 | 33.23 | 16.62 | 332.30 | 149.89 | 22.48 | 16.86 | 224.80 | 337.20 |
| 13 | 238.11 | 35.72 | 17.86 | 357.20 | 155.51 | 23.33 | 17.50 | 233.30 | 349.95 |
| 14 | 255.97 | 38.40 | 19.20 | 384.00 | 161.34 | 24.20 | 18.15 | 242.00 | 363.00 |
| 15 | 275.17 | 41.28 | 20.64 | 412.80 | 167.39 | 25.14 | 18.86 | 251.40 | 377.10 |
| 16 | 295.81 | 44.37 | 22.19 | 443.70 | 173.67 | 26.05 | 19.54 | 260.50 | 390.75 |
| 17 | 317.99 | 47.70 | 23.85 | 477.00 | 180.18 | 27.03 | 20.27 | 270.30 | 405.45 |

[1] Market Price represents 10 times earnings per share in each year.

[2] Market Price represents 15 times earnings per share in each year.

dividend would result in the yield advancing from 5.0% to 7½%.

2. Column IX shows the market price for the other extreme if that price advanced proportionately with the increase in dividend so that the yield with a 75% payout is 5.0%, the same as with the 50% payout.

For most companies neither of these extremes would be true. With an advance in dividend payout from 50% to 75% there might be some increase in price, but not to the extent that the yield would be the same.

In addition to the effect on market price, allowance should be made in the table and chart for the greater amount of dividends which would be received by stockholders with the higher payout. This has not been done because it would overcomplicate the tables. You can do so if you wish by subtracting the lower cash dividend payments from the higher. This will not change the principle we are trying to show.

In order to clarify the figures in the table, now let's look at them on the chart at the top of the page. However, perhaps you have lost sight of what we are trying to show. Remember, we previously said that the ultimate test of dividend policy is what it will do to the market price of a stock over the long run. We are here trying to obtain some idea of what might happen for a company earning 10% on its equity if it increased the payout. We assumed that with a 50% payout we would have a market price to produce a yield of 5.0%. This is shown on the chart by the solid line. Our next step was to increase the payout to 75%, but at first not increase the price, so that the yield with the higher dividend went up to 7½%. This is shown by the lower dotted line. Obviously, if this situation occurred, the 50% payout would be preferable, because there would be better market action by the common stock. Next we assumed the other extreme. With the payout increased to 75%, the market price increased so that the yield was 5.0%, the same as with a 50% payout. This is shown by the top dotted line. If the market reacted to the dividend increase in that manner, the higher payout would be preferable. As previously stated, it would be unlikely that either of these extremes would occur with these wide differences in payout. Therefore, deciding upon what payout is best necessitates a decision as to where the dotted line would fall with a dividend change. We will say more about this shortly.

First, let's look at another variable which materially affects the situation, that is, the return earned on the common stock. Increase the return from 10% to 15% and call this company with the higher return Company *B;* then look at the same type of picture. These figures are shown in table and chart form on pages 47A-B. Note that with the higher return on the common, the advantages of plowback rather than payout substantially increase. Even in the extreme case, with the yield the same when the dividend is increased, the lower payout will produce a better market price after twelve years. Thus, the more a company can earn on its common, the more reason for plowback. As noted for the previous table, allowance should be made for the difference in dividends which the stockholders would receive but, again, this does not change the idea the table shows.

Where does this lead us?

Companies, able to earn at a high rate of return, can probably do more for the market price of their stock if their dividend payout is on the low rather than on the high side. At the extreme for low payout are the speculative types of new ventures which attract investors who are seeking capital gains and who do not want dividends. Companies which are low earners, but have relatively stable earnings, can probably do more for the market price of their stock by having a liberal dividend policy. This policy will attract the investors with more interest in cash income than appreciation. At the extreme for high payout are those companies with a low rate of earnings, but of a stable nature, whose stocks sell primarily on a yield rather than an earnings basis.

Where the balance lies for each company will depend on the company's own circumstances.

It would be easy to make a decision regarding dividend policy if you could obtain a large sample of companies like your own with different payouts and prepare a table of correlation between market price and earnings per share, and market price and dividends per share. This would be helpful in deciding on the influence of payout on market price. However, market price is affected by so many other factors which have a bearing on the quality and outlook for earnings, that for most types of companies it would be impossible to obtain an adequate comparable sample. Even if such figures could be obtained, they should be used with great caution. Some clues can be found by studying companies of a similar nature and observing the effect of payout on the market price of their stocks rather than trying to apply correlation tables. This must be done with due allowance for other factors which affect price. It is often difficult. It might be helpful to discuss with security analysts the different companies and why one stock sells higher than another, in order to be able to interpret the figures properly. Therefore, a final decision on payout can best be made by starting from the correct premises, observing all data available, and applying sound judgment.

A few words of caution should be added about interpreting the effect of a dividend change on the market price of stock. In the first place, the effect on the market price may occur before the day on which the changed payment occurs. Investors will anticipate the effect as soon as they have any idea of an impending move. A more important consideration is that practically any dividend alteration may cause a market reaction when it becomes known. This may be due to the dividend itself, but it also may be due to investors interpreting the action as an indication of a change in the outlook for the company's earnings. This is caused by investors being aware that the directors must consider a company's prospects when deciding on dividend policy. Therefore, in viewing how payout may affect price, be cautious about using price around the time of a change in policy.

Furthermore, it should be realized that the investor will study a company's policy over a long period of time in evaluating dividend policy. For this reason, whatever action a company takes, may have some prolonged effect on its stock. This cannot be overemphasized. Therefore, in establishing a policy or making any change, a company must keep in mind the long-range point of view. Take, for example, the American Telephone and Telegraph Company which maintained its $9 dividend in the 1930's when it was not earned in certain years. Undoubtably this has had a marked effect on the stock for a long period of time.

A company's characteristics may change over a period of time; one that started out as a speculative venture may mature into a more stable type. Management in reviewing dividend policy should have in mind such changes. If a company decides on a change in policy, it should consider that some stockholders might have been attracted to the company because of its past policy. While a change would result in an over-all benefit, it might temporarily disturb some stockholders. Therefore, in making a change a company should proceed so as to have as little unfavorable reaction as possible.

### *Effect of Senior Securities*

One factor which affects variability of earnings and the payout ratio, not yet discussed, is the amount of senior securities in the capital structure. Other things being equal, the more senior securities the greater will be the variability of the earnings for the common equity, since the earnings are farther out on the limb.

Suppose Company *X* earns 10% on a $100,000,000 capital structure, consisting of 100% common equity, and Company *Y* also earns 10% on its capital structure, which consists of $50,000,000 of preferred stock, with a 6% dividend rate, and $50,000,000 of common equity. The company with all common stock would experience the lower risk arising from variability of earnings.

This is shown in the following figures:

| | *Company X* | *Company Y* |
|---|---|---|
| Preferred | | $ 50,000,000 |
| Common Equity | $100,000,000 | 50,000,000 |
| TOTAL | 100,000,000 | 100,000,000 |
| Earnings | 10,000,000 | 10,000,000 |
| Preferred Dividends | | 3,000,000 |
| Balance for Common | $ 10,000,000 | $ 7,000,000 |
| Dividends | 5,000,000 | 3,500,000 |
| Payout for Common Dividends | 50% | 50% |
| Payout for Common and Preferred Dividends | | 65% |

Company *Y* has the preferred dividends to pay as well as the common; combined, they total $6,500,000, which represents 65% of the income available. It is a heavier burden on earnings than for Company *X*. To put it another way, if Company *X*'s income were cut in half the dividend would still be earned, but not so for Company *Y*.

Preferred stock was used rather than debt for illustrative purposes, as it eliminated the problem of interest being deductible for tax purposes; but the same principle applies for all types of senior obligations. They add to the variability of earnings per share because of the leverage and require a lower payout ratio. Therefore, in observing any particular company's payout ratio, that company's capital structure must be kept in mind.

### *Effect of New Common Stock Issue*

Another factor to keep in mind in establishing a payout ratio policy, is the effect of a new offering of common stock. The new stock dilutes earnings per share and correspondingly increases the payout ratio. This is indicated from the figures given below.

| *Dividend Payout Ratio Before Common Financing* | *Dividend Payout Ratio Immediately After Common Financing* | |
|---|---|---|
| | *1 for 10 Offering* | *1 for 5 Offering* |
| 50% | 55% | 60% |
| 70% | 77% | 84% |

Of course, it would be expected that this would be only a temporary situation and that the dilution would be offset when earnings materialize on the new capital. However, for a company which has to raise a large amount of money through the sale of common in advance of earnings development, it is a factor to weigh.

PAYOUT RATIOS

| | *Average* | *1959* | *1958* | *1957* | *1956* | *1955* |
|---|---|---|---|---|---|---|
| All Corporations[1] | 56% | 56% | 64% | 55% | 52% | 49% |
| Moody's Common Stock Averages[2] | | | | | | |
| 125 Industrials | 58 | 59 | 69 | 58 | 56 | 49 |
| 25 Railroads | 52 | 57 | 57 | 59 | 47 | 40 |
| 24 Utilities | 69 | 68 | 69 | 71 | 69 | 69 |
| 15 Banks | 57 | 53 | 59 | 57 | 57 | 60 |
| 10 Insurance Companies[3] | 68 | 47 | 62 | 109 | 72 | 49 |
| Electric Utility Industry[4] | 72 | 70 | 71 | 72 | 74 | 72 |

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[1] *Survey of Current Business,* July 1959, U. S. Department of Commerce, Income Number, Page 9. Payout is for both preferred and common dividends. Payout for common alone would be slightly lower.

[2] *Moody's Industrial Manual 1960.* Blue section, page a, 26.

[3] Fire and casualty insurance companies.

[4] *Federal Power Commission, Annual Reports.* Classes A and B Privately Owned Electric Utilities.

## EXAMPLES OF PAYOUT RATIOS

We will now refer to some actual payout ratios. There are shown (pg. 50) data for all corporations, for five groups of different types of companies in the Moody's Common Stock averages, and for the electric utility industry.

As a sample of dividend payout ratios for individual industrial companies, the exhibit at the end of this chapter shows figures for the last five years for the 125 companies included in Moody's Industrial Common Stock Average grouped by type of company. Where there are five companies or more in a group, an average is given. They are not necessarily presented to show what policy should be followed, but just what has been done. There is such a wide variation that it would be possible to rationalize the choice of almost any ratio from these data. The average figures for these companies for 1955-59 can be summarized as follows:

| | *Number of Companies* | |
|---|---|---|
| *Payout* | *Number* | *% of Total* |
| Under 30% | 4 | 3.2% |
| 30 to 39 | 6 | 4.8 |
| 40 to 49 | 25 | 20.0 |
| 50 to 59 | 38 | 30.4 |
| 60 to 69 | 23 | 18.4 |
| 70 to 79 | 21 | 16.8 |
| 80 to 89 | 5 | 4.0 |
| 90 and over | 3 | 2.4 |
| | 125 | 100.0% |

The extremes of low and high payout are due to special situations and should be disregarded for our present purpose. If you study the extremes carefully, you undoubtedly will find a good reason for them. At times a company may have what appears to be a high payout policy. This may be due to the fact that the company's earnings have been poor; a low payout may be due to high earnings, non-recurring items in earnings, etc. Thus, no conclusion regarding a company's policy should be drawn merely from a glance at its payout ratio. One must make a careful analysis of all the facts.

The types of dividend for the 125 companies in Moody's Industrial Common Stock Average for the years 1955-1959 are summarized below. Without a study of each company's policy, which we have not made, it would be impossible to classify them according to our previous description of different types of dividends. However, the following classifications of cash dividend payments may be of interest.

| *Between 1955 and 1959* | *Number of Companies* |
|---|---|
| Increasing (no reductions in between) | 71 |
| Unchanged Throughout | 13 |
| Fluctuating (includes increases and decreases) | 26 |
| Decreasing (no increases in between) | 12 |
| No Payments (includes two dividends eliminated in recent years) | 3 |
| | 125 |

As a closing word on the matter of cash dividend payments, it should be obvious that it may be difficult to determine scientifically the best policy for a particular company with great exactitude. There are many variables affecting the final answer which cannot be mathematically evaluated with precision. For this reason, there is a band of reasonableness rather than an exact figure. The essential point is that a company's policy should be determined on the basis of correct premises and reasoning, with full appreciation of the importance of the long run, both in establishing dividend policy, and the effect that the policy may have.

## NEEDS FOR EARNED SURPLUS

If current earnings are not sufficient to cover the dividend payment, then past accumulated earnings in earned surplus will have to be used. Seldom does the lack of earned surplus hinder a company's ability to pay dividends, unless a company has experienced some serious financial difficulties in the past. Usually the trouble arises from lack of current earnings and a decision on the part of the management to conserve cash. A company will think twice before borrowing money to pay dividends.

There is little to say on the subject of earned surplus, as far as dividend payments are concerned, but it should not be entirely disregarded. Earned surplus should be sufficient to take care of dividends when earnings are poor, as well as to provide for special deductions for various corporate purposes. Earned surplus may be eroded as a result of write-off of worthless assets or other accounting adjustments. When new shares are offered, the earned surplus per share will decrease in proportion to the new number of shares. Stock dividends require a transfer of earned surplus, a subject which will be covered in this chapter.

The amount of earned surplus may come to the fore when a company does some debt financing. Purchasers of the debt may require the company to freeze some of the earned surplus against use for dividend payments. The purpose of this maneuver is to prevent a company from dissipating its cash through dividends not currently earned. The severity of the restriction will depend on the lenders' appraisal of the strength of the company's credit and the danger that the company might be hurt by excessive payments. A typical type of freeze permits dividends to be paid only out of earnings accruing after the debt is issued. In addition, a certain amount of earned surplus previously accumulated may also be made available. Generally, this restriction is not a serious matter, but a company should guard against being too limited. Actually, a lender would have no reason to restrict a company too severely unless the company was in poor financial condition. It is to the advantage of a lender to keep the common stock attractive so that the new common can be sold and thus add to the protection of the senior securities.

If a company has preferred stock outstanding, there is more reason to watch earned surplus, because there is more need to continue preferred dividend payments even if not earned. How large the earned surplus needs to be to take care of dividend payments will depend on the particular company, especially as regards possible erosion through write-offs, expected common financing, stock dividends, debt restrictions, etc.

Can earned surplus be too large? Not from a purely financial point of view. A company may, however, prefer not to show a large earned surplus for some public relations reason. If so, it would be a simple matter to transfer some of it to capital surplus through one means or another. In the relatively stable electric utility field, where the prospect of erosion of surplus through write-offs does not seem to be a major problem, a rule of thumb is sometimes used as follows: earned surplus should be about three times dividend requirements. Earned surplus for all Class A and B electric companies[6] actually is close to this figure for dividend payments on the preferred and common.

Figures for industrial companies are not indicative of what they require, because undoubtedly most of them have far more than needed for dividend purposes. For example, of the first quarter of the 125 companies listed by type in the exhibit at the end of this chapter, earned surplus averages about 12 times the preferred and common dividend requirements, with an approximate range of from 3 to 52 times.

The above comments refer to the matter of earned surplus from the point of view of dividend purposes alone. As previously emphasized, it would be expected that as earnings are retained, the earned surplus would build up to provide growth for the stockholders.

## INFORMATION ABOUT DIVIDEND POLICY

There was a time when it was difficult for a stockholder to obtain complete information about a company's earnings and operations. Now most companies are doing a good job in this respect; yet relatively little is said about dividends. In some annual reports only a brief comment about dividend payments is tucked away in the last part. Dividends are dear to stockholders' hearts and they are one of the first things for which they will look. They tend to be resentful when dividends are reduced, although the managements may have no alternative due to circumstances outside their control. The resentment may arise from the secrecy with which dividend policy is guarded.

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[6] *Federal Power Commission, Annual Report.* **Class A and B Privately Owned Electric Utilities.**

Admittedly, there are limitations concerning what can be said about dividend payments. At least, there should be a clear statement in the annual report of what was paid each quarter and the total for the year, and also for the previous year. If there has been any change in the quarterly rate, it calls for an explanation. At the time of the change, it is important that the press and financial services receive a complete story. If in the previous year there had been a change in quarterly rate, a comment about it should be repeated. Further, there seems to be room for a discussion of some of the factors which affected the decision regarding dividend payments and the relationship between the payments and earnings.

Many companies include in their annual reports financial statistics for a period of ten years. This should show dividend payments by years with the percentage of payout. A brief story regarding the changes in the past and the reasons might not be out of line. If dividend payments are affected by restrictions imposed by regulatory authorities or senior securities, this should be carefully explained, particularly if it might have any immediate effect on payments.

The question of talking about future dividend payments is a debatable one. Most companies will shy away from such a policy and certainly no one can criticize them for doing so. For a company with relatively stable earnings, something might be said in carefully guarded language, such as the statement about the extra dividend made by the company mentioned above. Another example of a well-worded statement follows:

> Regular quarterly dividends of 50 cents per share were paid on the common stock aggregating $2 per share for the fiscal year, which represents a cash distribution of approximately 70 percent of earnings available for the common shares, thus continuing the policy of liberal distribution of dividends on the common stock.
>
> Subsequent to the close of the business last year, your directors, at a regular meeting of the board, increased the quarterly dividend from 50 cents to 55 cents per share payable December 15. In the opinion of the management, past and prospective earnings justify this increase in the rate of dividend and it is expected that such increase can be maintained with a fair margin on the increased number of shares to be outstanding following completion of the common stock financing this year.

## STOCK DIVIDENDS

Now we come to an intriguing and controversial subject, that is, stock dividends, which are dividends paid in shares of stock. Opinion is quite divided on the subject. It is almost a special field by itself, and if you are trying to obtain the broad concepts of long-term financing management, you can skip this part for the present. However, even if your company has no intention of using stock dividends, it is hard to evade the topic if you are in the top echelon of a publicly-owned company. You may encounter the subject in many ways. At the annual meeting, stockholders may ask about your company's policy pertaining to it, a member of the board may broach the subject, some security analyst may ask the reasons why you have or haven't used it, you may receive letters from stockholders or your own management may wonder if it should use stock dividends.

The subject of stock dividends is not always easily understood, which accounts for much of the disagreement. Even those who do understand it thoroughly may disagree as to whether it is beneficial. As with some other financial questions, it is hard to obtain statistics which separate each of its effects from other unrelated influences.

Before going over the points that must be weighed in deciding whether to declare a stock dividend, it is essential that the effect on the company and stockholders be thoroughly analyzed. Therefore, we will first spend some time on such an analysis.

We will start with an example. A company has 1,000,000 shares of common stock outstanding. It earns $1,000,000 available for the common stock, or $1.00 per share. It pays total dividends of $500,000 or 50¢ per share. The total book value of the common stock is $10,000,000 or $10.00 per share.

The company declares a 5% stock dividend. This means that it will issue to its stockholders 50,000 new shares without receiving anything for those shares. A holder of 100 shares before the stock dividend will receive five new shares, a holder of 20 shares before the stock dividend will receive one new share, etc.

A holder of less than 20 shares will receive a fraction of a new share. The question of how to handle the fractional shares is a matter of mechanics. It must be done properly because it will effect your stockholder relations, but we are interested in the principles.

Now, look at the "just before" and "just after" picture in tabular form, assuming that the total earnings are $1,000,000 and that the dividend rate is kept at 50¢ per share.

| | *Before* | *After* |
|---|---|---|
| Shares Outstanding | 1,000,000 | 1,050,000 |
| Total Earnings | $1,000,000 | $1,000,000 |
| Earnings per Share | $1.00 | $0.95 |
| Dividends per Share | $0.50 | $0.50 |
| Total Dividend Requirements | $500,000 | $525,000 |
| Payout | 50.00% | 52.50% |
| Total Book Value of Common | $10,000,000 | $10,000,000 |
| Book Value per Share | $10.00 | $9.52 |

What happened? Essentially three things:[7]

1. The company's assets, which are not shown in the table, stayed the same, because nothing was received by the company for the new shares issued. It had no greater assets on which to earn more money.

2. The earnings per share and book value per share were decreased in proportion to the stock dividend—$1.00 to $0.95 for the earnings per share and $10.00 to $9.52 for the book value per share.

3. Since the cash dividend rate per share was kept the same, the total amount of dividends increased, and with the same total earnings, this increased the payout from 50.00% to 52.50%.

What happened to the stockholders? For the sake of simplicity, take a holder with 100 shares. Again, look at the "just before" and "just after" picture.

| | *Before* | *After* |
|---|---|---|
| Shares Owned | 100 | 105 |
| Earnings per Share | $1.00 | $0.95 |
| Earnings on Total Shares Owned | $100 | $100 |
| Book Value per Share | $10.00 | $9.52 |
| Book Value of Total Shares Owned | $1,000 | $1,000 |
| Dividends per Share | $0.50 | $0.50 |
| Dividends on Total Shares Owned | $50.00 | $52.50 |

The stockholder had 105 shares "after" as compared to 100 "before." Because of the proportionate decrease in the earnings per share and book value per share, his total shares represented the same total earnings and total book value afterwards as before, $10.00 each for earnings and $1,000 each for book value. The company and stockholder had more shares, but they were proportionately less valuable in terms of earnings per share and book value per share. The stockholder received the same dividend rate per share, but more total dividends because he had more shares.

Summarized, the effects on the company and stockholder are:

*Company:* 5% more shares outstanding; total book value and total earnings the same with proportionate decrease in per share figures; 5% more total cash dividends, since the rate per share was kept the same with the payout increasing from 50% to 52.50%.

*Stockholder:* 5% more shares having 5% less earnings per share and book value per share, with the same dividend rate but 5%

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[7] There is a transfer of earned surplus to stated value of stock or capital surplus as discussed subsequently, but this is not of consequence in this comparison.

more total dividends because of the greater number of shares.

If the company had decreased the dividend rate 5% to keep the same total amount paid out in dividends and thus the same payout ratio, the stock dividend would have been a pure "paper" transaction. The company and stockholder would have had more shares, but they would have been proportionately less valuable in terms of earnings, dividend and book value per share. What prevented the above example from being a pure "paper" transaction was the fact that the dividend rate was kept the same, resulting in more total dividends to pay as well as for stockholders to receive.

The above discussion was necessary because much of the erroneous thinking regarding stock dividends arises from a failure to understand the "paper" nature of the transaction—basically more paper worth less per unit.

Before we discuss the possible gains from stock dividends, a supplementary explanation is worthwhile. What happens if a stockholder holds or sells his stock dividend? In order to explain the effect, we will carry our example a little farther; it will help us in understanding what a company does for its stockholders by declaring a stock dividend. We will take two different companies over a period of years, Company *A* paying stock dividends and Company *B* paying none. The facts about our two companies are:

1. Both companies earn $1,000,000 available for common in the first year, and have 1,000,000 shares outstanding. Therefore, the earnings per share are initially $1.

2. Total earnings available for the common increase 5% each year. This is different from our previous example, in which the total earnings remained the same, for just before and after. We will extend the figures for three years. We need not extend them farther because the effect is the same each year.

3. Company *A* distributes a 5% stock dividend each year, while Company *B* does not. Note for subsequent discussion that the derived market value of the stock dividend for Company *A*, assuming a price of 10 times earnings, would be 50¢. This is equivalent to the retained earnings per original share, with the cash dividend policy described below. It works out this way: the price of the stock at 10 times earnings is $10 per share. With a 5% stock dividend each old share would receive 1/20 of a new share of stock with a market value of 50¢.

4. The cash dividend at the start is 50¢ per share for each company. Both companies pay out total dividends equal to 50% of the total earnings each year.

Since earnings are increasing at a rate of 5% each year for Company *A*, with a 5% stock dividend each year, the cash dividends per share remain the same each year.

Company B increases the cash dividend rate 5% each year so that the two companies pay out the same total dividends. Actually, were a company to increase the dividend rate it would not do so in such small amounts with fractions of a cent. These figures are used to facilitate comparison, and to present the idea properly.

We will also have a different stockholder for each company: Stockholder I, owning at the beginning of the first year 100 shares of Company *A;* Stockholder II, owning at the beginning of the first year 100 shares of Company *B.*

Each of these stockholders will take two actions with regard to their stock, in order to keep in the same relative position in their respective companies:

Action #1 in which both stockholders maintain all their stock.

Action #2 in which Stockholder I sells his stock dividend each year and Stockholder II sells an amount of his stock in Company B equal to the stock dividend in Company A.

This seems a complicated way to make something simple, but its purpose is to assure a firmer foundation for further thinking about stock dividends. See the tables on pp. 56-57 to see what drama, or really lack of drama, unfolds for Stockholders I and II in Action #1 and #2 with their holdings in Companies *A* and *B.*

### COMPANY *A*

Pays a 5% Stock Dividend Each Year After All Cash Dividends Are Paid

| *TOTAL* | *1st year* | *2nd year* | *3rd year* |
|---|---|---|---|
| Earnings | $1,000,000 | $1,050,000 | $1,102,500 |
| Dividends | $ 500,000 | $ 525,000 | $ 551,250 |
| Retained Earnings | $ 500,000 | $ 525,000 | $ 551,250 |
| No. of Shares | 1,000,000 | 1,050,000 | 1,102,500 |
| *PER SHARE* | | | |
| Earnings | $1.00 | $1.00 | $1.00 |
| Dividends—50% Payout | $0.50 | $0.50 | $0.50 |
| Retained Earnings | $0.50 | $0.50 | $0.50 |
| *EFFECT ON STOCKHOLDER I* | | | |
| *Action #1—Stockholder Retains Stock Dividends* | | | |
| No. of Shares Held | 100 | 105 | 110.25 |
| Earnings for All Shares Held | $100.00 | $105.00 | $110.25 |
| Dividends for All Shares Held | $ 50.00 | $ 52.50 | $ 55.125 |
| *Action #2—Stockholder Sells Stock Dividends* | | | |
| No. of Shares Remaining | 100 | 100 | 100 |
| Earnings Available on Remaining Shares | $100 | $100 | $100 |
| Dividends on Remaining Shares | $ 50 | $ 50 | $ 50 |

Here is what the tables show:

1. Company *A*, because of the 5% stock dividend, has more shares outstanding than Company *B*. That is the only difference between the companies.

2. Stockholders I and II are in exactly the same position in Actions #1 and #2, as regards total earnings and total dividends. The only difference is that Stockholder I has more shares with proportionately less per share earnings and dividends, due to the stock dividend. To summarize, Company *A* has done nothing for its stockholder as compared to Company *B* except to have more shares with proportionately less earnings and dividends per share—a pure "paper" transaction.

One more word of explanation before we go into the pros and cons. You will need to know how to figure the yield when a stock dividend is issued. Yield may affect market price, and it is of direct interest to stockholders. The yield of a stock is the relationship of the price per share to the annual cash dividend per share. If a stock pays $5 in dividends per share in a year and the price of the stock is $100 per share, the yield is 5%.

Some confusion may occur when a company pays a stock dividend. We can make good use of Company *A* and Company *B* in our explanation. The following are some yields for our two companies.

During the first year before the declaration of the stock dividend by Company A:

$$\text{Yield—Company } A = \frac{\$0.50}{\text{Market Price per Share.}}$$

$$\text{Yield—Company } B = \frac{\$0.50}{\text{Market Price per Share.}}$$

At the end of the first year, after all cash dividends have been paid, Company *A* announces that its cash dividend will be kept at $0.50 per share but that a 5% stock dividend will be paid, and Company *B* announces that its cash dividend will be increased 5% to $0.525 per share. What is the prospective yield for each company at that time?

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COMPANY *B*

Pays No Stock Dividend

(Company *B* and its stockholder II are in exactly the same position as Company *A* and its stockholder I, except that Company *A* has more shares outstanding.)

| *TOTAL* | *1st year* | *2nd year* | *3rd year* |
|---|---|---|---|
| Earnings | $1,000,000 | $1,050,000 | $1,102,500 |
| Dividends | $ 500,000 | $ 525,000 | $ 551,250 |
| Retained Earnings | $ 500,000 | $ 525,000 | $ 551,250 |
| No. of Shares | 1,000,000 | 1,000,000 | 1,000,000 |
| *PER SHARE* | | | |
| Earnings | $1.00 | $1.05 | $1.10 |
| Dividends—50% Payout | $0.50 | $0.525 | $0.55 |
| Retained Earnings | $0.50 | $0.525 | $0.55 |
| *EFFECT ON STOCKHOLDER II* | | | |
| *Action #1—Stockholder Retains All Stock* | | | |
| No. of Shares Held | 100 | 100 | 100 |
| Earnings for All Shares Held | $100.00 | $105.00 | $110.25 |
| Dividends for All Shares Held | $ 50.00 | $ 52.50 | $ 55.125 |
| *Action #2—Stockholder Sells Enough Stock Each Year to be Equivalent to Stock Dividend of Company A*[1] | | | |
| No. of Shares Remaining | 100 | 95 | 91 |
| Earnings Available on Remaining Shares | $100 | $100 | $100 |
| Dividends on Remaining Shares | $ 50 | $ 50 | $ 50 |

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[1] Sale each year takes place after all cash dividends are paid.

$$\text{Pros. Yield—Company } A = \frac{\$0.50 \text{ plus } \$0.025}{\text{Mkt. Pr./Share.}}$$

The $0.025 is the cash dividend that will be received next year on the 1/20 of a share of stock dividend which is still attached to the share of stock of Company *A* before it goes ex-stock dividend.

$$\text{Pros. Yield—Company } B = \frac{\$0.525}{\text{Mkt. Pr./Share.}}$$

Just after Company *A* goes ex-stock dividend, here is the picture for each company:

$$\begin{array}{l} \text{Pros. Yield for Company } A \\ \text{on Original Share of Stock} \end{array} = \frac{\$0.50}{\begin{array}{c}\text{Mkt. Pr./Share,} \\ \text{Ex-Stock Dividend}\end{array}}$$

$$\begin{array}{c} \text{On } 1/20 \text{ of New Share} \\ \text{Received as Stock Dividend:} \end{array} = \frac{\$0.025}{\begin{array}{c}\text{Mkt. Pr./}1/20 \\ \text{New Share.}\end{array}}$$

$$\text{Pros. Yield—Company } B = \frac{\$0.525}{\text{Mkt. Pr./Share.}}$$

Why all these figures to explain a simple subject like yield? We haven't yet pointed out the confusion that may arise with a stock dividend. It is sometimes erroneously contended that the yield for Company *A* should be figured not by including the cash dividend which will be received on the stock dividend, but by including the market value of the stock dividend. This, of course, is fallacious reasoning, as the above tables for Companies *A* and *B* show. The market value of the stock dividend is part of the stockholder's capital. If he sells it, he is selling some of his capital on which he would pay capital gains, just as though Stockholder II in Company *B*, Action #2 sold some of his stock in order to supplement his cash needs.

The market value of the 1/20 new share is derived from the original share by taking away 1/20 of its value at the moment the original share goes ex-dividend.

After this introduction about stock dividends, it is hoped that you still have some interest in whether your company should pay one. We can now go over each point which might suggest what your company should do; it is essential that these points be clearly separated in weighing their importance.

### *Increase the Number of Shares*

A stock dividend merely increases the number of shares outstanding without the company receiving any proceeds from its issuance. Is this any reason for a company to declare a stock dividend? Possibly. For reasons to be discussed under the subject of stock splits, a company may wish to have its stock sell in what is known as a popular price range, of roughly between $20 and $50. If a company's earnings per share are large and the market price correspondingly high, a stock dividend will reduce the earnings per share and tend to reduce the market price.

A company might use a stock dividend for this purpose, but the same could be accomplished with a stock split, as will be shown shortly.

### *Increase Cash Paid Out in Dividends*

From the figures above, it is obvious that as long as a company keeps the cash dividend rate per share the same and pays a stock dividend, the total cash dividends paid will be increased by the same percentage as the stock dividend. In our example, the 5% stock dividend resulted in 5% more cash dividends paid by the company for each year in the future. This will mean a corresponding increase in the total dividends received by the stockholders. To this extent, a stock dividend does not "conserve cash" as sometimes contended.

If the total earnings do not increase, the payout percentage will increase correspondingly. Therefore, if a company does not wish to increase the cash dividend rate per share for some public relations reason, it may use a stock dividend as a device to increase the cash paid out and still keep the rate the same. If there is no compelling public relations reason, it would appear that a straight increase in the cash dividend per share would be preferable. It would be more thoroughly understood by the unsophisticated stockholder and would eliminate the cost of issuing a stock dividend.

### *May Be Liked by Stockholders*

Some companies have said that one reason they pay a stock dividend is because their stockholders like it; it has some psychological value. Some managements seem to tie on to this as the principal reason for adopting a stock dividend policy. In this connection, the following are examples of the types of evidence relied upon:

1. Letters and other communications from stockholders. Certainly, this is no true sample. It merely represents the opinion of a small group of stockholders who take the time to write.

2. A survey of small stockholders who purchased stocks which paid stock dividends. Such a survey is likely to be a biased one. Those represented must have liked stock dividends in the first place or they would not have been attracted to these stocks. What about stockholders who bought stocks of companies that didn't pay stock dividends? What about the large stockholders? Stockholders have a right to expect the company to follow policies acceptable to holders of a majority of the stock.

3. A letter survey to a large group of individual stockholders. This fails in coverage of large institutional holders. Again, the replies would necessarily represent the vocal group who would bother to send in the return card.

If a company relies on a presumed stockholder preference, it needs an accurate sampling of its own stockholders so that there will be a true opinion both on the basis of number of stockholders and number of shares. The final decision must be based on the percentage of stock, because control of the company is on that basis, as it should be. For this reason, large institutional holdings are important. Some large institutional investors dislike stock dividends as they require expensive paper handling. As an example, an institution which supervises the investments of a large number of individuals will not only have a lot of paper work to do, but also may have to communicate with the individual holders in order to inform them of the stock dividend. It even may have to request approval for the action to be taken. When stocks are held in trust accounts, complications may sometimes arise by reason of state laws which affect the allocation of cash between life tenant and remainderman.

In the survey, it would be quite important to frame certain preliminary questions in order to determine whether the stockholder surveyed understood the import of a stock dividend. This would add to the problem of the management making a decision, but any survey which did not make this distinction would be quite misleading. There is a vast difference between the reply of a stockholder who understands and one who does not understand a stock dividend's significance. Obviously there are a large number of stockholders in the latter category. A company executive who says it makes no difference whether stockholders understand the significance of a stock dividend, as long as they like it, would seem to be basing his decision on superficial reasoning. How many other actions could be justified on the same grounds?

In such a survey, the alternative to paying a stock dividend should be presented. Why wouldn't stockholders tend to seize upon a stock dividend as being "better than nothing" —although we have no proof that it is better than nothing. If a company planned to pay a regular stock dividend with a fixed cash rate, then the alternative without a stock dividend would be a gradual increase in the cash dividend. A questionnaire should be so worded as to provide for the latter alternative and not merely a fixed cash rate, which would obviously be misleading.

Therefore, if a company relies on the fact that holders of the majority of its stock like stock dividends, it should have sound evidence to justify that reliance.

In weighing the so-called psychological value, it should also be remembered that stockholders like to see growth in their stock. Continued payment of stock dividends will correspondingly restrict growth in earnings per share. If stockholders fail to take this into account in their comparison of such a stock with one which has not paid a stock dividend, there may be a psychological disadvantage.

What seems most important is that a company should not rely upon a show of stockholder preference by itself as a crutch for adopting such a policy. It costs a company money to issue stock dividends. Therefore, a company should have concrete reasons for their use which will actually benefit the holders of a majority of the stock in a tangible manner.

### *Do They Affect Market Price of Stock?*

Some companies have relied on a possible favorable market action from a stock dividend as a reason for its use. It is unfortunate to hear some people say that X Company paid a stock dividend and its stock went up. Standing by itself, such a statement is meaningless. Think of the many other things that may have made the stock go up—increased earnings, improved outlook for the company, improvement in the industry, a bull stock market, etc. In fact, stock dividends usually make their appearance with advancing earnings and during a bull market; so it is not surprising to find some people automatically associating stock dividends with a market increase.

The only significant factor as far as the stock dividend is concerned is how the market action of the stock would have appeared if all factors were eliminated other than the effect of the stock dividend itself. That requires considerable work and the use of a large sample of companies in order to come up with a significant answer. A superficial study on this point is worthless.

It does not appear that evidence generally backs up this reason. On the basis of logic, why should it? A stock dividend gives the company no more cash to work with and the added shares dilute the earnings proportionately. Why should stockholders pay more for the earnings and cash dividends of a company because it issues a stock dividend? You can't pick yourself up by your bootstraps. The most complete published study[8] on this point concluded that a stock dividend by itself resulted in a temporary improvement in the price, because of temporary market interest in the stock generated by the stock dividend, but that this died out shortly. On the average, there was no permanent favorable effect even with a regular stock dividend, aside from that caused by the increase in the cash dividend which accompanies some stock dividends. Beware of superficial studies on this point.

### *A Way to Capitalize Earned Surplus*

If a company has a large earned surplus, it may wish to change some of it to capital surplus or stated value of common for public relations reasons. Many banks are limited in the amount they can lend to one borrower to a percentage of capital stock and capital surplus, and therefore, to increase their lending limit, will make transfers from their undivided profit accounts.

No uniform method has been established for the accounting treatment of a stock dividend. The New York Stock Exchange requires listed companies to have "transferred from earned surplus to the permanent capitalization of the company (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of such shares. While it is impracticable to define 'fair value' exactly, it should closely approximate the current share market price adjusted to reflect issuance of the additional shares."[9]

It may be unnecessary for a company to use a stock dividend in order to capitalize earned surplus. It may be possible to make the transfer to capital surplus or stated value of common by an action of the board of directors or by some other corporate action. The company should investigate the feasibility of more readily handling this matter.

However, if a company contemplates declaring a stock dividend, it should examine the effect it may have on earned surplus. There should be enough earned surplus to make possible the above transfer accompanying the stock dividend. There also should be enough remaining so that the cash dividend policy will not be hampered.

### *Permit Some Stockholders to Realize Capital Gains—How Important?*

This argument is based on the fact that those stockholders who want capital gains can retain their stock dividend. This is an unsound reason based on the unproved assumption that a stock dividend in itself permanently benefits the market price. If a stockholder wants capital gains rather than income, he would be just as well off if the company paid no stock dividend, retained the earnings and built up his investment. Furthermore, all the expense involved in issuing the stock dividend is for nought as far as he is concerned. The extent to which more cash dividends are paid out because of the greater amount of stock after a stock dividend could be handled just as well by an increase in the cash dividend rate.

### *Permit Some Stockholders to Supplement the Cash Dividend Income—How Important?*

Companies relying on this argument say that issuing stock dividends gives all stockholders a choice of whether to keep their stock dividends, or sell them and by so doing supplement their cash income. We have already seen that those stockholders who hold the dividend gain nothing. Therefore, the decision to declare a stock dividend must be based on the benefits to be gained by those who sell it. Now, let's look at it from their point of view.

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[8] "Evaluation of Stock Dividends," by C. Austin Barker, *Harvard Business Review*, July-August 1958.

[9] New York Stock Exchange Company Manual A-235, July 21, 1935.

Some of those who advance this reason suggest that a company pay a stock dividend with a market value about equal to the retained earnings; in effect, stockholders who sell their stock dividend would be getting the same result as if more earnings were paid out in dividends. This seems like a fine argument, but follow it through a little farther.

It is claimed there is a tax advantage, because a stock dividend is taxable on a capital gains basis. As far as the tax factor is concerned, the size of the stockholder's income will affect the savings in taxes from capital gains. Generally, it is contended that the small stockholders with low income are the ones who need to supplement their cash income. They would be the least benefited by the capital gains advantage. However, if a stockholder wishes to supplement his cash income by sale of some of his principal, he can do so without the stock dividend, merely by the sale of some of his original holdings. This is what was shown in the previous table with Company *B*.

Those in favor of a stock dividend will contend that perhaps the small stockholders cannot divide up their holdings easily so as to sell off part. If the company pays a stock dividend with the market price equivalent to the retained earnings, then a stockholder is in an easier position to sell an amount equivalent to those retained earnings, by selling the stock dividend. In other words, the company is providing a convenient mechanical means for a stockholder to sell a small portion of his principal. It would appear that if this argument is to hold, a majority of the stockholders should desire a stock dividend for this purpose. Otherwise, the company would be going to all the expense to satisfy a few stockholders. One of the most important considerations is the final showing as to how much of the stock dividend is sold by a company's stockholders. For example, one company that adopted a stock dividend, using this as one of the arguments, found that stockholders owning only a very small percentage of its stock sold the stock dividend. Could it possibly justify the expense of such a policy for holders of such a small amount of stock?

When a stock dividend is sold by a stockholder, the stockholder has to pay the brokerage fee. For example, a holder of 40 shares who received a stock dividend of 5% would receive two shares. If the stock sold for $25, he would receive $50. If the stock were listed on the New York Stock Exchange he would have to pay a brokerage commission of $3, or 6%, in addition to other miscellaneous charges.

These costs to the stockholders who sell may be reduced by some effort and expense on the part of the company. A company can work out a means to handle the sale for stockholders wishing to sell. One company devised an ingenious idea of sending out a return card with the stock dividend notice so that a stockholder could indicate whether he wanted to receive the stock dividend, round out his fractional shares, or have the company sell it. The company then pooled all the stockholders requests and sold the shares in one transaction through an underwriting house. The cash was remitted to the individual stockholders. This involves the expense [10] of registration with the Securities and Exchange Commission.

In connection with stockholders selling their stock dividends, it should be noted that this may cause a depressing effect on the market to the extent that the supply of the stock coming on the market is increased.

### *Company Obtains Equity Capital without High Cost of New Stock Financing—How Important?*

The basis for this argument is that if the company pays a stock dividend, stockholders are not inconvenienced by a lower cash dividend policy, and also, that the market value of all shares is not seriously affected by the lack of growth in cash dividends. In this instance stockholders can supplement their cash income by sale of the stock dividend if they choose to do so. With a lower cash dividend, the company gets new equity capital through more retained earnings. It avoids having to sell the equivalent in new common stock and paying the heavy financing costs.

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[10] To the extent that the expenses of sale of stock dividends are charged to those who sell, they should not be considered as any disadvantage to the other stockholders.

Does it sound like an alluring argument? It does, because it apparently offsets the fact that only a few stockholders who sell their stock dividend may be benefited by all the expense. Continue along this line. If only a few stockholders sell their stock dividend, doesn't it show that the company could have eliminated the stock dividend, save that expense, and still had as much cash for corporate purposes? The only stockholders inconvenienced would be the few who wished to sell their stock dividends and thus divest themselves of part of their holdings.

To justify a stock dividend on the basis of this argument requires a large number of stockholders who wish to sell their dividend—in fact, stockholders representing a majority of the shares. Again, it overlooks the fact that stockholders can sell some of their principal to supplement their income even without a stock dividend, barring, of course, the mechanical problem of breaking down their holdings into proper amounts, which is primarily a problem for their broker. It is not just a question of whether the company gets the advantage of retained earnings rather than the expense of selling new common stocks, but whether those earnings could not be retained just as well without the expense of a stock dividend.

### *May Be Only Type of Dividends Possible*

If a company has senior obligations outstanding, they may contain a provision limiting the earned surplus available for payment of cash dividends on the common stock. Stock dividends generally are excepted from such restrictions, for the obvious reason that they are just a piece of paper and do not in themselves deplete a company's assets. Therefore, if a company runs into a period of bad earnings and does not have adequate free-earned surplus, stock dividends may be the only type that a company can issue.

### *A Way Out for Directors and Management if the Cash Dividend Has to Be Cut*

Stock dividends should not be used as a means to offset a necessary cut in the cash dividend in order to save directors and management embarrassment. This is merely a psychological factor, and will not in the end be of any tangible benefit to the stockholders.

### *Conclusion on Stock Dividends*

At least, whatever a company's decision on stock dividends, it should not consider such a step as being exceptionally important, since a stock dividend is only chopping up one piece of paper into smaller pieces. In concluding this section on stock dividends, we must return to the problem of the cash dividend. A company has to face the question of whether it would be better off if its stockholders received a different cash dividend. Remember, a company has to decide on a dividend policy which will produce the best market price over the long run. A company should not proceed to stock dividends as an excuse for avoiding an appropriate cash dividend. If stock dividends are considered, the decision should be based on a thorough evaluation of each of the points discussed above.

In making your analysis, it might be well to study what happens when companies eliminate a stock dividend, and their reasons. If stock dividends are so beneficial, it would appear that eliminating them would produce adverse results. Mere opinions by managements either favoring or against stock dividends should not be used as a basis for making a decision. However, the following brief summary of the comments made by the officer of a company which eliminated them is of interest because of the reasons for the decision:

> To halt the constant dilution which was taking place.
>
> The regular small stock dividend was not being recognized in the price of the stock by the investors as being worth any more than a corresponding percentage increase in the cash dividends.
>
> The payment of the stock dividend was of itself rather expensive, and because fractional shares were paid in cash, it did not save as much money as it appeared to save.
>
> The point was finally reached where additional equity was required because of the magnitude of the expansion program, and it was decided to issue Convertible Preferred. Continuance of stock dividends would dilute this conversion price on the Convertible Preferred thereby increasing dilution.
>
> From a stockholder's reaction, many arguments were received from trusts and investment funds of the headaches caused by small common stock dividends. They did not like the bookkeeping or the necessity of selling small blocks of stock to maintain earnings.
>
> Many people felt that the cash dividend should be increased.
>
> Since discontinuing the stock dividend, practically no complaints were received from existing stockholders.

Perhaps this discussion about stock dividends may sound like an argument against them. Its only purpose is to help you avoid in your analysis for your company the approach sometimes used of a conglomeration of mixed-up arguments that might be blown away like a piece of paper when unraveled and analyzed point by point.

In 1959, of the 1,116 companies listed on the New York Stock Exchange, 186 paid stock dividends or 17%. In the four previous years the percentages were 12%, 15%, 17% and 12%. The New York Stock Exchange has an arbitrary rule to distinguish between a stock dividend and a stock split, the former representing an increase in stock of 24% or less.

In 1959, of the 8,200 corporations for which Standard and Poor's Corporation[11] keeps dividend records, 502 companies paid stock dividends. This included 70 stock dividends of 25% or more, for companies not listed on the New York Stock Exchange. For the four previous years the number of stock dividends for this list of companies was: in 1958—359; 1957—432; 1956—412; and 1955—314.

If you do decide to use stock dividends and believe in the principle of keeping your stockholders fully informed about subjects close to their hearts, you might wish to include an explanation in your annual report. Give the reasons for such action, the alternative if you had not taken such a step, and the results as to the number of shares represented by stockholders who sold and retained the stock dividend. Stockholders would need that information if they were to communicate with you on the subject.

## STOCK SPLITS

A stock split is technically not a form of dividend and does not generally belong in this chapter. However, it is so much like a stock dividend that it really should follow that discussion. In fact, as has already been mentioned, the New York Stock Exchange has an arbitrary rule that the issuance of 24% stock or less is a stock dividend, and generally 25% or more is a stock split. This indicates the close association between the two. Practically all of the discussion on stock dividends applies to stock splits and, in order to avoid repetition, this part presupposes that you have read that section. In a stock split there is a different treatment of earned surplus, as compared to a stock dividend. When there is a stock split, the earned surplus is unaffected. The only change on the balance sheet is the par or stated value of the stock, which remains the same in total but is reduced per unit according to the number of shares increased.

By way of review, we can use the example of a 2-for-1 stock split for a company which has 100,000 shares outstanding, earns $6.00 per share, pays $3.00 per share in cash dividends and has a market price of $60.

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[11] Standard & Poor's Corporation, *The Outlook*, January 4, 1960 (Vol. 32, No. 1) page 995.

| | *Before Split* | *After Split* |
|---|---|---|
| Earnings Available for Common | $1,000,000 | $1,000,000 |
| Shares Outstanding | 100,000 | 200,000 |
| Earnings per Share | $10.00 | $5.00 |
| Dividends per Share (assuming a reduction to correspond to the stock split) | $ 5.00 | $2.50 |
| Payout Ratio | 50% | 50% |
| Total Dividends Paid | $500,000 | $500,000 |
| Market Price of Stock | $100.00 | $50.00 |
| Earnings Price Ratio | 10 times | 10 times |
| Dividend Yield | 5.0% | 5.0% |

A stock split merely gives a stockholder an additional piece of paper to represent the same ownership. If the cash dividend rate is lowered to correspond with the increase in number of shares, as above, then the total cash income will be the same. Each stockholder will have twice as many shares, each worth one half as much, but in total worth the same.

Only if the cash dividend rate is kept at the same rate on the new shares as the old, or is not decreased proportionately to the stock split, will the stockholders receive more dividend income. Under these circumstances there might be a permanent increase in the market price of the stock, but this would be due to the dividend increase and not the stock split itself. Careful studies[12] of the effect of stock splits on the market price, with adjustment for changes in the general market and cash dividend, concluded that when there is no corresponding cash dividend increase, there will be no permanent increase in the market price. A temporary market spurt may occur, which may last up to six months, because of the temporary market interest generated in the stock.

Then why stock splits? As indicated in the comments on stock dividends, there exists what is known as a popular price range for common stocks, somewhere between $20 and $50 per share. People seem to like to buy stocks in one hundred share lots, known as a round lot. If the price per share is too high, the purchase of 100 shares or a multiple thereof would require a large amount of capital.

The effects of a stock split on brokerage commissions for buying stocks listed on the New York Stock Exchange are shown on next page. When an odd lot investor becomes a round lot[13] investor as the result of a split, there is some decrease. If an investor continues in the odd lot class after the split, his commission will increase somewhat. But an investor who was in the round lot class before the split will pay higher brokerage commissions after it. Therefore, splitting a stock may, under certain circumstances, result in an increase in the brokerage commission.

When added interest is shown in a stock in the more popular price range, there is a tendency for the number of stockholders to increase.[14] Ownership is broadened thereby, which might facilitate sale of new common stock when needed.

It is unwise to split a stock so that its price is too low. A stock which gets below $10 per share may be considered by some investors as belonging in the "cat and dog" class. Here again, it is primarily a matter of psychology. Nevertheless, it is unwise to over-split so that the market price of the stock will fall into that class during a bear market or when the company has poor earnings. This brings to mind that a company can reverse-split its stock if the price gets too low. Stockholders may consider it an unpopular action because it indicates past failure. However, any effect on the market price from the reverse split itself would not be likely to be more than temporary. In 1958, four companies split down their stock (a reverse split) in ratios ranging from 1-for-4 to 1-for-25.[15]

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[12] "Effective Stock Splits," and "Stock Splits in a Bull Market," by C. Austin Barker, *Harvard Business Review*, January-February 1956, and May-June 1957 respectively.

[13] Shares traded on the New York Stock Exchange in 100 share units or multiples thereof are known as round lots; less than 100 shares is an odd lot. Some shares are traded in 10 share units which is then the measure for a round lot.

[14] See previously referred to articles by C. Austin Barker.

[15] Standard & Poor's Corporation, *The Outlook*, December 29, 1958 (Vol. 30, No. 52) page 486.

| | *Odd Lot before Split* | *Round Lot after Split* | *Odd Lot before Split* | *Odd Lot after Split* | *Round Lot before Split* | *Round Lot after Split* |
|---|---|---|---|---|---|---|
| Market Price | $100 | $ 50 | $100 | $ 50 | $100 | $ 50 |
| Shares Bought and Sold | 50 | 100 | 30 | 60 | 100 | 200 |
| Total Value | $5,000 | $5,000 | $3,000 | $3,000 | $10,000 | $10,000 |
| Total Brokerage Commission | $ 42.00 | $ 44.00 | $ 32.00 | $ 32.00 | $ 49.00 | $ 88.00 |
| Extra Cost for Odd Lot[1] | 12.50 | — | 7.50 | 15.00 | — | — |
| Total Charge | $ 54.50 | $ 44.00 | $ 39.50 | $ 47.00 | $ 49.00 | $ 88.00 |
| Total Charge as % of Total Value | 1.09% | 0.88% | 1.32% | 1.57% | 0.49% | 0.88% |

[1] In figuring total cost to buy an odd lot, when the round lot is figured in 100 share units, add an ⅛ to the round lot market price when it is under $40, add a ¼ when it is $40 and over. When an odd lot is sold, the ⅛ and ¼ are deducted.

Total stock splits in each of the last five years for all companies for which Standard and Poor's Corporation[16] keeps records, consisting of about 8,200 companies, have been as follows: 1959—320; 1958—63; 1957—152; 1956—161 and 1955—181.

In 1959, for the 1,116 companies listed on the New York Stock Exchange, there were 109 stock splits, or about 10%. The percentages for the previous four years were 2%, 4%, 9% and 8% respectively.

Stocks which split 2-for-1 accounted for 59 of the total 109 splits in 1959. The market price range before the 2-for-1 split for these stocks is shown below in order of price.

PRICE RANGES, 1959[1] BEFORE 2-FOR-1 STOCK SPLITS

164 – 84
157 –137¼
150¾– 72⅝
144¾– 76
140½– 99
131½– 64¼
121 – 95
117 –109½
116¼– 90⅝
114⅝– 89
108 – 95¾
106 – 91⅝
101⅞– 43½
99½– 92
97 – 84½
97 – 46⅝
94 – 72½
94 – 52
92¼– 47½
91½– 82½
91¼– 45⅝
90¾– 56¼
89¾– 64
88 – 77¼
87¾– 74¾
87½– 78⅝
86 –36⅜
85½– 67½
85 – 67½
83½– 60¼
83 – 35¼
82½– 62
79¾– 56
78½– 69
77¾– 53
75½– 61½
74½– 65
72¾– 54½
71 – 46¼
70¾– 48¼
69¼– 49
69 – 47½
68⅞– 60¾
66⅜– 55¾
65¼– 55
64½– 43
64 – 46½
63¾– 52
61¼– 49½
60 – 55¼
56 – 25½
55¾– 47½
54½– 42½
53½– 43¾
52⅞– 44½
50¾– 30¼
45⅛– 36½
42¾– 29¾
35¾– 22

[1] Range from January 1, 1959, to time of split, except where split was in first quarter, and then the 1958 price range was used. One stock split twice during the year, but figures are only shown for the range before the first split. Prices were as reported in *The Commercial and Financial Chronicle*, and by Moody's Investors Service, Inc.

There is no need to go overboard on the matter of popular price range. Many companies with stocks which have sold above that range for many years have been popular with investors. The price ranges in 1959 for the ten United States Companies listed on the New York Exchange with the largest number of common stockholders of record were as follows:

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[16] Standard & Poor's Corporation, *The Outlook*, December 28, 1959 (Vol. 31, No. 52) page 485. Standard and Poor's Corporation does not have any arbitrary rule for distinguishing between a stock dividend and a stock split. It reports them according to the designation used by the paying company.

| Company | Common Stockholders of Record[1] | Price Range 1959 |
|---|---|---|
| American Tel. & Tel. | 1,736,681 | 89 – 74⅞ |
| General Motors | 760,442 | 58⅞– 45 |
| Standard Oil (N.J.) | 569,600 | 59⅛– 45⅝ |
| General Electric | 404,316 | 99⅞– 74 |
| U. S. Steel | 268,247 | 108⅞– 88¼ |
| Ford Motor | 234,360 | 93½– 50¾ |
| Socony Mobil Oil | 221,413 | 52¼– 38¾ |
| Du Pont de Nemours | 202,061 | 278¾–202½ |
| Bethlehem Steel | 201,636 | 59⅛– 49¼ |
| Columbia Gas System | 182,545 | 24⅝– 19¾ |

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[1] New York Stock Exchange Fact Book 1960. Based on data available early in 1960. These 10 issues accounted for 4,800,000 stockholders of record or about 20 per cent of the total for all NYSE-listed common stocks.

As a matter of fact, it may be suggested that a lot more fuss and feathers is made over stock splits than is justified. However, if your stock does sell at a relatively high price, you may wish to look into the subject with the idea of attracting more stockholders. Other reasons may be suggested for the use of a stock split, such as those advanced for a stock dividend. For example, there may be some special reason why you may wish to use a stock split as a means to increase the cash dividend payout by not decreasing the dividend rate proportionately with the stock split.

EXHIBIT

EARNINGS PER SHARE, DIVIDENDS PER SHARE AND PAYOUT RATIOS FOR 125 COMPANIES

INCLUDED IN MOODY'S INDUSTRIAL COMMON STOCK AVERAGE
Grouped According to Moody's Industry Classification
(Exhibit prepared by Bohdan J. Kekish)

| | | *1959* | *1958* | *1957* | *1956* | *1955* | *5-yr. Av.* |
|---|---|---|---|---|---|---|---|
| *AGRICULTURAL IMPLEMENTS* | | | | | | | |
| Allis-Chalmers Mfg. Co.[1] | *Earnings* | $2.47 | $2.34 | $2.11 | $2.42 | $3.03 | |
| | *Dividends* | 1.25 | 1.25 | 2.00 | 2.00 | 2.00 | |
| | *Payout* | 51% | 53% | 95% | 83% | 66% | 70% |
| International Harvester Co. | *Earnings* | 5.10 | 2.69 | 2.88 | 3.16 | 3.60 | |
| | *Dividends* | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | |
| | *Payout* | 39% | 74% | 69% | 63% | 56% | 60% |
| *AIR-CONDITIONING* | | | | | | | |
| Borg-Warner Corp.[1] | *Earnings* | 4.36 | 2.34 | 3.81 | 4.01 | 5.17 | |
| | *Dividends* | 2.00 | 2.00 | 2.40 | 2.30 | 1.925 | |
| | *Payout* | 46% | 85% | 63% | 55% | 37% | 57% |
| Carrier Corp. | *Earnings* | 3.62 | 3.27 | 3.17 | 5.26 | 4.82 | |
| | *Dividends* | 1.60 | 2.00 | 2.40 | 2.40 | 2.35 | |
| | *Payout* | 44% | 61% | 76% | 46% | 49% | 55% |
| *AUTOMOBILES* | | | | | | | |
| Chrysler Corp. | *Earnings* | 0.62[d] | 3.88[d] | 13.75 | 2.29 | 11.49 | |
| | *Dividends* | 1.00 | 1.50 | 4.00 | 3.00 | 4.00 | |
| | *Payout* | — | — | 29% | 131% | 35% | 65%[2] |
| Ford Motors Corp.[3] | *Earnings* | 8.24 | 2.12 | 5.40 | 4.60 | 8.51 | |
| | *Dividends* | 2.80 | 2.00 | 2.40 | 2.40 | 3.27 | |
| | *Payout* | 34% | 94% | 44% | 52% | 38% | 52% |
| General Motors Corp. | *Earnings* | 3.06 | 2.22 | 2.99 | 3.02 | 4.30[1] | |
| | *Dividends* | 2.00 | 2.00 | 2.00 | 2.00 | 2.17 | |
| | *Payout* | 65% | 90% | 67% | 66% | 50% | 68% |
| Mack Trucks Inc.[1] | *Earnings* | 5.71 | 3.03 | 4.33 | 4.75 | 3.29 | |
| | *Dividends* | 1.80[12] | 1.80 | 1.80 | 5%st. | 10%st. | |
| | *Payout* | 32% | 59% | 42% | 00 | 00 | 44%[2] |

| | | *1959* | *1958* | *1957* | *1956* | *1955* | *5-yr. Av.* |
|---|---|---|---|---|---|---|---|
| *AUTOMOBILE PARTS* | | | | | | | |
| Elect. Auto-Lite Co. | *Earnings* | 4.60 | 1.68 | 4.71 | 1.46 | 6.31 | |
| | *Dividends* | 2.50 | 1.40 | 2.50 | 2.00 | 2.50 | |
| | *Payout* | 55% | 78% | 53% | 137% | 40% | 73% |
| Elect. Storage Battery Co. | *Earnings* | 3.63 | 2.38 | 3.44 | 3.20[5] | 2.32[5] | |
| | *Dividends* | 2.00 | 2.00 | 2.00 | 1.70 | 1.60 | |
| | *Payout* | 55% | 84% | 58% | 63% | 69% | 66% |
| Fruehauf Trailer Co.[1] | *Earnings* | 1.88 | 0.88[4] | 0.21[4] | 0.96[4] | 1.77 | |
| | *Dividends* | 00 | 00[d] | 0.70[12] | 1.40[12] | 1.00[12] | |
| | *Payout* | — | — | 333% | 146% | 56% | 178%[2] |
| Timken Roller Bearing Co.[1] | *Earnings* | 5.60 | 2.10 | 3.89 | 4.50 | 4.56 | |
| | *Dividends* | 2.40 | 2.00 | 2.25 | 2.00 | 2.00 | |
| | *Payout* | 43% | 95% | 58% | 44% | 44% | 57% |
| *AVIATION* | | | | | | | |
| Boeing Airplane Co.[1] | *Earnings* | 1.65 | 4.01 | 5.49 | 4.82 | 4.67 | |
| | *Dividends* | 1.00[12] | 1.00[12] | 1.00[12] | 1.25[12] | 1.625 | |
| | *Payout* | 61% | 25% | 18% | 26% | 35% | 33% |
| Douglas Aircraft Co., Inc. | *Earnings* | 8.86[d] | 4.41 | 8.28 | 8.96 | 7.65 | |
| | *Dividends* | 1.00 | 2.50[12] | 4.00 | 4.00 | 4.00 | |
| | *Payout* | — | 57% | 48% | 45% | 52% | 51%[2] |
| North American Aviation, Inc.[1] | *Earnings* | 3.78 | 3.34 | 4.22 | 3.59 | 4.71 | |
| | *Dividends* | 1.60 | 1.60 | 2.00 | 1.925 | 2.25 | |
| | *Payout* | 42% | 48% | 47% | 54% | 48% | 48% |
| United Aircraft Corp.[5] | *Earnings* | 4.25 | 6.40 | 7.96 | 5.88 | 5.12 | |
| | *Dividends* | 2.50 | 3.00 | 2.50 | 2.50 | 2.29 | |
| | *Payout* | 59% | 47% | 33% | 43% | 45% | 45% |
| *BUILDING MATERIALS & EQUIPMENT* | | | | | | | |
| Amer. Radiator & S. S. Corp. | *Earnings* | 1.35 | 0.85 | 1.05 | 1.65 | 2.22 | |
| | *Dividends* | 0.75 | 0.55 | 1.10 | 1.40 | 1.34 | |
| | *Payout* | 56% | 65% | 105% | 85% | 60% | 74% |
| Johns-Manville Corp.[1] | *Earnings* | 3.74 | 2.83 | 2.48 | 3.50 | 3.67 | |
| | *Dividends* | 2.00 | 2.00 | 2.00 | 2.25 | 2.13 | |
| | *Payout* | 53% | 71% | 81% | 64% | 58% | 65% |
| Otis Elevator Co.[1] | *Earnings* | 2.91 | 2.10 | 1.79 | 1.74[7] | 1.51 | |
| | *Dividends* | 1.20 | 1.00 | 1.00 | 0.975 | 0.813 | |
| | *Payout* | 41% | 48% | 56% | 56% | 54% | 51% |
| U. S. Gypsum Co. | *Earnings* | 5.70 | 5.05 | 4.78 | 5.01 | 4.98 | |
| | *Dividends* | 3.00 | 2.85 | 2.75 | 2.50 | 2.20 | |
| | *Payout* | 52% | 56% | 58% | 50% | 44% | 52% |
| *CAN MANUFACTURING* | | | | | | | |
| Amer. Can Co.[8] | *Earnings* | 2.42 | 2.78 | 2.51 | 2.92 | 3.00 | |
| | *Dividends* | 2.00 | 2.00 | 2.00 | 2.00 | 1.55 | |
| | *Payout* | 83% | 72% | 79% | 68% | 52% | 71% |
| Continental Can Co., Inc.[1] | *Earnings* | 3.21 | 3.51 | 3.52 | 3.71 | 3.22[9] | |
| | *Dividends* | 1.80 | 1.80 | 1.80 | 1.80 | 1.50 | |
| | *Payout* | 56% | 51% | 51% | 49% | 47% | 51% |

| | | *1959* | *1958* | *1957* | *1956* | *1955* | *5-yr. Av.* |
|---|---|---|---|---|---|---|---|
| *CEMENT* | | | | | | | |
| Lehigh Portland Cement Co. | *Earnings*[33] | 2.88 | 2.11 | 2.13 | 2.82 | 2.96 | |
| | *Dividends* | 1.00 | 1.00 | 1.00 | 0.95 | 0.80 | |
| | *Payout* | 35% | 47% | 47% | 34% | 27% | 38% |
| Lone Star Cement Corp.[1] | *Earnings* | 2.20[14] | 2.06 | 2.03 | 2.23 | 2.04 | |
| | *Dividends* | 1.30 | 1.20 | 1.10 | 1.10 | 1.04 | |
| | *Payout* | 60% | 58% | 54% | 49% | 51% | 54% |
| *CHEMICALS* | | | | | | | |
| Air Reduction Co., Inc. | *Earnings* | 3.79 | 3.44 | 4.31[9] | 4.20[9] | 3.21 | |
| | *Dividends* | 2.50 | 2.50 | 2.375 | 1.90 | 1.50 | |
| | *Payout* | 66% | 73% | 55% | 45% | 47% | 57% |
| Allied Chemical Corp.[1] | *Earnings* | 2.51 | 1.71[11] | 2.19[10] | 2.37 | 2.72 | |
| | *Dividends* | 1.575 | 1.50 | 1.50 | 1.50[12] | 1.50[12] | |
| | *Payout* | 63% | 88% | 69% | 63% | 55% | 68% |
| Columbian Carbon Corp. | *Earnings* | 4.28[33] | 2.22[11] | 2.64 | 3.00 | 3.91 | |
| | *Dividends* | 2.40 | 2.40 | 2.40 | 2.40 | 2.30 | |
| | *Payout* | 56% | 108% | 91% | 80% | 59% | 79% |
| Du Pont (E. I.) de Nemours & Co. | *Earnings* | 8.92 | 7.25 | 8.48 | 8.20 | 9.26 | |
| | *Dividends* | 7.00 | 6.00 | 6.50 | 6.50 | 7.00 | |
| | *Payout* | 78% | 83% | 77% | 79% | 76% | 79% |
| Eastman Kodak Co.[1] | *Earnings* | 3.23 | 2.57 | 2.55 | 2.57 | 2.33 | |
| | *Dividends* | 1.56 | 1.43 | 1.33[12] | 1.33 | 1.10[12] | |
| | *Payout* | 48% | 56% | 52% | 52% | 47% | 51% |
| Monsanto Chem. Co. | *Earnings* | 2.12 | 1.55 | 1.68 | 1.80 | 1.98 | |
| | *Dividends* | 1.00[12] | 1.00 | 1.00[12] | 1.00[12] | 0.92[12] | |
| | *Payout* | 47% | 65% | 60% | 56% | 46% | 55% |
| Union Carbide Corp. | *Earnings* | 5.70 | 4.15 | 4.45 | 4.86 | 4.83 | |
| | *Dividends* | 3.60 | 3.60 | 3.60 | 3.15 | 3.00 | |
| | *Payout* | 63% | 87% | 81% | 65% | 62% | 72% |
| | | | | | | (Grp. av.) | 66% |
| *COAL & COKE* | | | | | | | |
| Consolidation Coal Co.[1] | *Earnings* | 2.23 | 2.00 | 2.90 | 2.39[15] | 2.18 | |
| | *Dividends* | 1.25 | 1.20 | 1.20 | 1.20 | 1.00 | |
| | *Payout* | 56% | 60% | 41% | 42% | 46% | 49% |
| *DRUGS, MEDICINES & COSMETICS* | | | | | | | |
| Bristol-Myers Co.[1] | *Earnings* | 1.70 | 1.46[17] | 1.36[16] | 1.18 | 0.99 | |
| | *Dividends* | 0.85 | 0.72 | 0.67 | 0.58 | 0.50 | |
| | *Payout* | 50% | 49% | 49% | 49% | 50% | 49% |
| Parke, Davis & Co.[1] | *Earnings* | 2.09 | 1.89 | 1.89 | 1.20 | 0.97 | |
| | *Dividends* | 1.30 | 1.00 | 0.67 | 0.57 | 0.47 | |
| | *Payout* | 62% | 53% | 35% | 47% | 48% | 49% |
| Sterling Drug, Inc.[1] | *Earnings* | 2.65 | 2.42 | 2.38 | 2.14 | 2.01 | |
| | *Dividends* | 1.65 | 1.50 | 1.50 | 1.35 | 1.35 | |
| | *Payout* | 62% | 62% | 63% | 63% | 67% | 63% |
| *ELECTRICAL EQUIPMENT* | | | | | | | |
| General Elect. Co. | *Earnings* | 3.19 | 2.78 | 2.84 | 2.46 | 2.41 | |
| | *Dividends* | 2.00 | 2.00 | 2.00 | 2.00 | 1.60 | |
| | *Payout* | 63% | 72% | 70% | 81% | 66% | 70% |

| | | *1959* | *1958* | *1957* | *1956* | *1955* | *5-yr. Av.* |
|---|---|---|---|---|---|---|---|
| Minneapolis Honeywell Reg. Co.[1] | *Earnings* | 4.20 | 3.23 | 3.07 | 3.40[4] | 2.98[4] | |
| | *Dividends* | 1.85 | 1.75 | 1.75 | 1.75 | 1.50 | |
| | *Payout* | 44% | 54% | 57% | 51% | 50% | 51% |
| Westinghouse Elect. Corp.[1] | *Earnings* | 2.43 | 2.13[19] | 2.09[19] | 0.05[18] | 1.23 | |
| | *Dividends* | 1.05 | 1.00 | 1.00 | 1.00 | 1.00 | |
| | *Payout* | 43% | 47% | 48% | — | 81% | 55%[2] |
| *ELECTRONICS* | | | | | | | |
| Bendix Corp. | *Earnings* | 5.37 | 4.18 | 5.44 | 5.04 | 5.66 | |
| | *Dividends* | 2.40 | 2.40 | 2.40 | 2.40[12] | 2.10 | |
| | *Payout* | 45% | 57% | 44% | 47% | 37% | 46% |
| Texas Instruments, Inc. | *Earnings* | 3.59 | 1.84 | 1.11 | 0.72 | 0.50 | |
| | *Dividends* | nil | nil | nil | nil | nil | |
| | *Payout* | 00 | 00 | 00 | 00 | 00 | |
| *FOOD* | | | | | | | |
| Borden Co.[1] | *Earnings* | 2.61 | 2.53 | 2.57 | 2.51 | 2.31 | |
| | *Dividends* | 1.40 | 1.40[12] | 1.40 | 1.40 | 1.40[12] | |
| | *Payout* | 54% | 55% | 54% | 56% | 61% | 56% |
| Coca-Cola Co.[1] | *Earnings* | 2.62 | 2.37 | 2.36 | 2.29[20] | 2.15 | |
| | *Dividends* | 2.17 | 1.67 | 1.67 | 1.67 | 1.67 | |
| | *Payout* | 83% | 70% | 71% | 73% | 78% | 75% |
| Corn Prod. Co.[21] | *Earnings* | 3.04 | 3.00 | 2.54 | 2.41 | 2.43 | |
| | *Dividends* | 2.00 | 1.75 | 1.50 | 1.50 | 1.33 | |
| | *Payout* | 66% | 58% | 59% | 62% | 55% | 60% |
| General Foods Corp.[1, 26] | *Earnings* | 4.96 | 4.42 | 3.98 | 3.61 | 3.31 | |
| | *Dividends* | 2.55 | 2.20 | 1.95 | 1.775 | 1.55 | |
| | *Payout* | 51% | 50% | 49% | 49% | 47% | 49% |
| General Mills, Inc.[1, 36] | *Earnings* | 1.46 | 2.26 | 1.98 | 1.63 | 1.89 | |
| | *Dividends* | 1.05 | 1.00 | 1.00 | 1.00 | 0.92 | |
| | *Payout* | 72% | 44% | 51% | 61% | 49% | 55% |
| Nat'l. Biscuit Co. | *Earnings* | 3.57 | 3.18 | 3.18 | 2.90 | 2.59 | |
| | *Dividends* | 2.30 | 2.20 | 2.20 | 2.00 | 2.00 | |
| | *Payout* | 64% | 69% | 69% | 69% | 77% | 70% |
| Nat'l. Dairy Prod. Corp. | *Earnings* | 3.51 | 3.27 | 3.18 | 3.02 | 2.98 | |
| | *Dividends* | 1.95 | 1.80 | 1.80 | 1.75 | 1.60 | |
| | *Payout* | 56% | 55% | 57% | 58% | 54% | 56% |
| Swift & Co. | *Earnings* | 3.20 | 1.70 | 2.29[22] | 2.36[22] | 3.87 | |
| | *Dividends* | 1.60 | 2.00 | 2.25 | 2.60 | 2.50 | |
| | *Payout* | 50% | 118% | 98% | 110% | 65% | 88% |
| United Fruit Co. | *Earnings* | 1.39 | 2.60 | 3.59 | 3.45 | 3.82 | |
| | *Dividends* | 1.50 | 3.00 | 3.00 | 3.00 | 3.00 | |
| | *Payout* | 108% | 115% | 84% | 87% | 79% | 95% |
| Wrigley (Wm.) Jr. Co. | *Earnings* | 5.13 | 5.19 | 5.54 | 5.67 | 5.91 | |
| | *Dividends* | 4.50 | 4.50 | 4.50 | 5.00 | 5.00 | |
| | *Payout* | 88% | 87% | 81% | 88% | 85% | 86% |
| | | | | | | (Grp. av.) | 69% |

| *GLASS & GLASSWARE* | | *1959* | *1958* | *1957* | *1956* | *1955* | *5-yr. Av.* |
|---|---|---|---|---|---|---|---|
| | *Earnings* | 5.13 | 2.05 | 2.68[19] | 2.80[19] | 3.47 | |
| Libbey-Owens-Ford Glass Co. | *Dividends* | 2.55 | 1.80 | 1.80 | 1.80 | 1.58 | |
| | *Payout* | 50% | 88% | 67% | 64% | 45% | 63% |
| | *Earnings* | 5.20 | 4.82[24] | 4.55[23] | 4.49 | 4.42 | |
| Owens-Illinois Co. | *Dividends* | 2.50 | 2.50 | 2.50 | 2.50 | 2.125 | |
| | *Payout* | 48% | 52% | 55% | 55% | 48% | 52% |
| *MACHINERY, EQUIPMENT & TOOLS* | | | | | | | |
| | *Earnings* | 3.12 | 3.84 | 3.99 | 4.16 | 1.56 | |
| Blaw-Knox Co. | *Dividends*[12] | 1.40 | 1.25 | 1.20 | 1.20 | 1.20 | |
| | *Payout* | 45% | 33% | 30% | 29% | 77% | 43% |
| | *Earnings* | 1.68 | 1.16 | 1.44 | 2.02 | 1.35 | |
| Caterpillar Tractor Co.[1] | *Dividends* | 0.90 | 0.80 | 0.80 | 0.65 | 0.53 | |
| | *Payout* | 54% | 69% | 56% | 32% | 40% | 50% |
| | *Earnings* | 1.11 | 1.62 | 4.46 | 4.65[25] | 2.46 | |
| Cincinnati Milling Machine Co. | *Dividends* | 1.60 | 1.60 | 1.60 | 1.60 | 1.525 | |
| | *Payout* | 144% | 99% | 36% | 34% | 62% | 75% |
| | *Earnings* | 2.61 | 1.35 | 1.79 | 2.06 | 2.12 | |
| Clark Equipment Co.[1] | *Dividends* | 1.13 | 1.00 | 1.13 | 1.07 | 0.94 | |
| | *Payout* | 43% | 74% | 63% | 52% | 44% | 55% |
| | *Earnings* | 4.06 | 4.36 | 6.01 | 5.96 | 4.54 | |
| Ingersoll-Rand Co. | *Dividends* | 4.00 | 4.00 | 4.00 | 3.50 | 3.00 | |
| | *Payout* | 99% | 92% | 67% | 59% | 66% | 77% |
| | *Earnings* | 3.65 | 3.52 | 5.41 | 5.95 | 4.16 | |
| Link-Belt Co. | *Dividends* | 2.70 | 2.70 | 3.20 | 3.15 | 3.00 | |
| | *Payout* | 74% | 77% | 59% | 53% | 72% | 67% |
| | | | | | | | (Grp. av.) 61% |
| *MINING & PROCESSING* | | | | | | | |
| | *Earnings* | 2.52 | 1.96 | 3.55 | 4.24 | 4.18 | |
| Aluminum Co. of Amer. | *Dividends* | 1.20 | 1.20 | 1.20 | 1.20 | 0.95 | |
| | *Payout* | 48% | 61% | 34% | 28% | 23% | 39% |
| | *Earnings* | 1.74 | 2.53 | 3.94 | 6.67 | 5.52 | |
| Amer. Smelting & Refining Co. | *Dividends* | 1.00 | 1.50 | 3.00 | 3.50 | 2.80 | |
| | *Payout* | 57% | 59% | 76% | 52% | 51% | 59% |
| | *Earnings* | 5.53 | 3.16 | 4.23 | 12.85 | 7.52 | |
| Anaconda Co. | *Dividends* | 2.50 | 2.00 | 3.75 | 5.00 | 4.25 | |
| | *Payout* | 45% | 63% | 89% | 39% | 57% | 59% |
| | *Earnings* | 5.83 | 2.71 | 5.90 | 6.50 | 6.14 | |
| Int'l. Nickel Co. of Canada, Ltd. | *Dividends* | 3.00 | 2.60 | 3.75 | 3.75 | 3.75 | |
| | *Payout* | 51% | 96% | 64% | 58% | 61% | 66% |
| | *Earnings* | 5.19 | 5.44 | 7.32 | 13.23 | 11.60 | |
| Kennecott Copper Corp. | *Dividends* | 6.00 | 5.00 | 6.00 | 9.25 | 7.75 | |
| | *Payout* | 116% | 92% | 82% | 70% | 67% | 85% |
| | *Earnings* | 3.30 | 3.60 | 4.35 | 8.58 | 7.13 | |
| Phelps Dodge Corp.[28] | *Dividends* | 3.00 | 3.00 | 4.30 | 5.00 | 3.10 | |
| | *Payout* | 91% | 83% | 99% | 58% | 43% | 75% |

| | | *1959* | *1958* | *1957* | *1956* | *1955* | *5-yr. Av.* |
|---|---|---|---|---|---|---|---|
| St. Joseph Lead Co. | *Earnings* | 2.30 | 1.47 | 2.95 | 3.79 | 4.68 | |
| | *Dividends* | 1.00 | 1.00 | 2.00 | 3.00 | 3.00 | |
| | *Payout* | 43% | 68% | 68% | 79% | 64% | |
| | | | | | | (Grp. av.) | 64% |
| *MOTION PICTURES* | | | | | | | |
| Paramount Pictures Corp.[29] | *Earnings* | 4.47 | 7.15 | 2.47 | 4.43 | 4.49 | |
| | *Dividends* | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | |
| | *Payout* | 45% | 28% | 81% | 45% | 45% | 49% |
| *OFFICE EQUIPMENT* | | | | | | | |
| Burroughs Corp. | *Earnings* | 1.07[25] | 0.97 | 1.67 | 2.35 | 2.19 | |
| | *Dividends* | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | |
| | *Payout* | 93% | 103% | 60% | 43% | 46% | 69% |
| Int'l. Business Machines Corp.[1] | *Earnings* | 7.97 | 7.10 | 5.15 | 4.37 | 3.63 | |
| | *Dividends* | 2.03[12] | 1.73[12] | 1.53 | 1.27[12] | 1.07 | |
| | *Payout* | 25% | 24% | 30% | 29% | 29% | 27% |
| Nat'l. Cash Register Co. | *Earnings* | 2.52 | 2.19 | 2.57 | 2.62 | 2.33[1] | |
| | *Dividends* | 1.20 | 1.20 | 1.20 | 1.10[12] | 1.08 | |
| | *Payout* | 48% | 55% | 47% | 42% | 46% | 48% |
| Underwood Corp. | *Earnings* | 14.30[d] | 9.35[d] | 2.13[d] | 10.91[d] | 2.01 | |
| | *Dividends* | 00 | 00 | 0.40 | 1.10 | 1.50 | |
| | *Payout* | — | — | — | — | 75% | |
| *PAPER & PULP* | | | | | | | |
| Container Corp. of America[1] | *Earnings* | 1.83 | 1.35 | 1.36 | 1.71 | 1.52 | |
| | *Dividends* | 1.00 | 1.00 | 1.00 | 0.81 | 0.75 | |
| | *Payout* | 55% | 74% | 74% | 48% | 49% | 60% |
| Crown-Zellerbach Corp. | *Earnings* | 2.76 | 2.32 | 2.39 | 3.53 | 3.11[1] | |
| | *Dividends* | 1.80 | 1.80 | 1.80 | 1.80 | 1.53 | |
| | *Payout* | 65% | 78% | 68% | 51% | 49% | 62% |
| International Paper Co. | *Earnings* | 6.21 | 5.29[11] | 6.17 | 7.05 | 7.54 | |
| | *Dividends*[12] | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | |
| | *Payout* | 48% | 57% | 49% | 43% | 40% | 47% |
| Kimberly-Clark Corp.[35] | *Earnings* | 3.51 | 3.01 | 2.86 | 2.92 | 2.82 | |
| | *Dividends* | 1.80 | 1.80 | 1.80 | 1.80 | 1.725[12] | |
| | *Payout* | 51% | 60% | 63% | 62% | 61% | 59% |
| Union Bag-Camp Paper Corp. | *Earnings* | 2.57 | 2.13 | 2.49 | 3.02 | 2.44[37] | |
| | *Dividends* | 1.50 | 1.50 | 1.50 | 1.50 | 1.33 | |
| | *Payout* | 58% | 70% | 60% | 50% | 55% | 59% |
| | | | | | | (Grp. av.) | 57% |
| *PETROLEUM PRODUCING, REFINING, TRANSPORT. & DISTRIBUTING* | | | | | | | |
| Atlantic Refin. Co. | *Earnings* | 3.19[27] | 3.61 | 3.82 | 5.11 | 4.25 | |
| | *Dividends* | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | |
| | *Payout* | 63% | 55% | 52% | 39% | 47% | 51% |
| Continental Oil Co.[1] | *Earnings* | 2.85 | 2.41 | 2.38 | 2.65 | 2.38 | |
| | *Dividends* | 1.70 | 1.60 | 1.60 | 1.53 | 1.43 | |
| | *Payout* | 60% | 66% | 67% | 58% | 60% | 62% |

| | | *1959* | *1958* | *1957* | *1956* | *1955* | *5-yr. Av* |
|---|---|---|---|---|---|---|---|
| Ohio Oil Co. | *Earnings* | 2.76 | 2.45 | 3.16 | 3.14 | 3.14[1] | |
| | *Dividends* | 1.60 | 1.60 | 1.60 | 1.60 | 1.55 | |
| | *Payout* | 58% | 65% | 51% | 51% | 49% | 55% |
| Phillips Petroleum Co.[1] | *Earnings* | 3.05 | 2.45 | 2.80 | 2.77 | 2.78 | |
| | *Dividends* | 1.70 | 1.70 | 1.70 | 1.60 | 1.50 | |
| | *Payout* | 56% | 69% | 61% | 58% | 47% | 58% |
| Shell Oil Co.[1] | *Earnings* | 2.43 | 1.93 | 2.23 | 2.25 | 2.28 | |
| | *Dividends* | 1.025 | 1.00 | 1.00 | 1.00[12] | 1.00 | |
| | *Payout* | 42% | 52% | 45% | 45% | 44% | 46% |
| Sinclair Oil Corp. | *Earnings* | 2.95 | 3.23 | 5.18 | 5.98 | 5.68 | |
| | *Dividends* | 3.00 | 3.00 | 3.00 | 3.00 | 2.70 | |
| | *Payout* | 102% | 93% | 58% | 50% | 48% | 70% |
| Socony Mobil Oil Co.[1] | *Earnings* | 3.38 | 3.24 | 4.56 | 5.70 | 4.74 | |
| | *Dividends* | 2.00 | 2.00 | 2.50 | 2.30 | 2.00 | |
| | *Payout* | 59% | 62% | 55% | 40% | 42% | 52% |
| Standard Oil Co. Cal.[1] | *Earnings* | 4.01 | 4.08 | 4.56 | 4.24 | 3.66 | |
| | *Dividends* | 2.00 | 2.00 | 1.90 | 1.65 | 1.50[12] | |
| | *Payout* | 50% | 49% | 42% | 39% | 41% | 44% |
| Standard Oil (N. J.)[1] | *Earnings* | 2.91 | 2.62 | 3.96 | 4.11 | 3.61 | |
| | *Dividends* | 2.25 | 2.25 | 2.25 | 2.10 | 1.76 | |
| | *Payout* | 77% | 86% | 57% | 51% | 48% | 64% |
| | | | | | | | (Grp. av.) 56% |
| *PUBLISHING—MAGAZINES* | | | | | | | |
| Curtis Publishing Co. | *Earnings* | 0.65 | 0.22 | 1.29 | 1.09 | 0.40 | |
| | *Dividends* | 0.35 | 0.35 | 0.35 | 0.20 | 0.20 | |
| | *Payout* | 54% | 159% | 27% | 18% | 50% | 62% |
| *RADIO, TV & PHONOGRAPHS* | | | | | | | |
| Philco Corp. | *Earnings* | 1.67 | 0.61 | 0.93 | 0.01 | 2.13 | |
| | *Dividends* | 0.25 | 2%st. | 4%st. | 0.80[12] | 1.60 | |
| | *Payout* | 15% | — | — | — | 75% | 45%[2] |
| Radio Corp. of Amer. | *Earnings* | 2.59 | 2.01 | 2.55 | 2.65 | 3.16 | |
| | *Dividends* | 1.50 | 1.50 | 1.50 | 1.50 | 1.35 | |
| | *Payout* | 58% | 75% | 59% | 57% | 43% | 58% |
| *RAILWAY EQUIPMENT* | | | | | | | |
| ACF Industries, Inc.[35] | *Earnings* | 2.78 | 1.21 | 5.54 | 6.39 | 6.08 | |
| | *Dividends* | 2.50 | 2.875 | 4.00 | 4.00 | 3.75 | |
| | *Payout*[38] | 90% | (238%) | 72% | 63% | 62% | 72%[2] |
| Pullman, Inc. | *Earnings* | 5.87[27] | 3.52 | 6.67 | 5.71[30] | 4.34 | |
| | *Dividends* | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 | |
| | *Payout* | 68% | 114% | 60% | 70% | 92% | 81% |
| Westinghouse Air Brake Co. | *Earnings* | 2.71 | 2.10 | 2.89 | 2.86 | 2.98[27] | |
| | *Dividends* | 1.20 | 1.20 | 1.20 | 1.20 | 1.20 | |
| | *Payout* | 44% | 57% | 42% | 42% | 40% | 45% |
| *REFRACTORY PRODUCTS* | | | | | | | |
| Harbison-Walker Ref. Co.[1] | *Earnings* | 2.96 | 2.84 | 4.40 | 3.63 | 2.55 | |
| | *Dividends* | 1.80 | 1.80 | 1.70 | 1.40 | 1.13[12] | |
| | *Payout* | 61% | 63% | 39% | 38% | 44% | 49% |
| *RETAIL STORES* | | | | | | | |
| Kresge (S. S.) Co. | *Earnings* | 2.30 | 2.50 | 2.62 | 2.60 | 2.52 | |
| | *Dividends* | 1.60 | 1.60 | 1.60 | 1.60 | 1.60 | |
| | *Payout* | 70% | 64% | 61% | 62% | 64% | 64% |

| | | *1959* | *1958* | *1957* | *1956* | *1955* | *5-yr. Av.* |
|---|---|---|---|---|---|---|---|
| Kress (S. H.) & Co. | *Earnings* | 0.80 | 2.03 | 3.00 | 3.48 | 3.81 | |
| | *Dividends* | 2.00 | 2.00 | 2.00 | 2.50 | 3.00 | |
| | *Payout* | (250%) | 99% | 67% | 72% | 81% | 80%[2] |
| Macy (R. H.) & Co. | *Earnings* | 3.76 | 3.20 | 3.44 | 3.07[31] | 2.64 | |
| | *Dividends* | 2.00 | 2.00 | 2.00 | 1.80 | 1.60 | |
| | *Payout* | 53% | 62% | 58% | 59% | 61% | 59% |
| Marshall Field & Co. | *Earnings* | 4.51 | 3.51 | 3.56 | 3.54 | 3.49 | |
| | *Dividends* | 2.375 | 2.25 | 2.25 | 2.25 | 2.00 | |
| | *Payout* | 53% | 64% | 63% | 64% | 57% | 60% |
| May Dept. Stores Co. | *Earnings* | 3.28 | 2.90 | 3.26 | 3.31 | 3.10 | |
| | *Dividends* | 2.20 | 2.20 | 2.20 | 2.20 | 1.90 | |
| | *Payout* | 67% | 76% | 69% | 66% | 61% | 68% |
| Montgomery Ward & Co., Inc.[1] | *Earnings* | 2.00 | 2.08 | 2.21 | 2.65 | 2.61 | |
| | *Dividends* | 2.00 | 2.25 | 2.25 | 2.625 | 2.375 | |
| | *Payout* | 100% | 108% | 103% | 99% | 91% | 100% |
| Penney (J. C.) Co. | *Earnings* | 6.26 | 5.69 | 6.00 | 5.68 | 5.60 | |
| | *Dividends* | 4.25 | 4.25 | 4.25 | 4.25 | 3.95 | |
| | *Payout* | 68% | 75% | 71% | 75% | 71% | 72% |
| Sears, Roebuck & Co. | *Earnings* | 2.64 | 2.21 | 2.15 | 2.20 | 2.15[1] | |
| | *Dividends* | 1.30 | 1.10 | 1.00 | 1.15[12] | 1.00[12] | |
| | *Payout* | 49% | 50% | 47% | 52% | 46% | 49% |
| Woolworth (F. W.) Co. | *Earnings* | 4.03 | 3.34 | 3.44 | 3.57 | 3.52 | |
| | *Dividends* | 2.50 | 2.50 | 2.50 | 2.50 | 2.50 | |
| | *Payout* | 62% | 75% | 73% | 70% | 71% | 70% |
| | | | | | | | (Grp. av.) 69% |
| *RETAIL STORES—GROCERY* | | | | | | | |
| Amer. Stores, Inc. | *Earnings* | 4.92 | 6.15 | 5.97 | 5.81 | 5.48 | |
| | *Dividends*[12] | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | |
| | *Payout* | 41% | 32% | 33% | 34% | 36% | 35% |
| Kroger Co. | *Earnings* | 2.06 | 1.76 | 1.70 | 1.47 | 1.29 | |
| | *Dividends* | 0.95 | 0.725 | 0.67[12] | 0.67[12] | 0.67 | |
| | *Payout* | 46% | 41% | 39% | 45% | 52% | 45% |
| Safeway Stores, Inc.[1] | *Earnings* | 2.80 | 2.60 | 2.43 | 2.04 | 1.08 | |
| | *Dividends* | 1.25 | 1.10 | 0.90 | 0.80 | 0.80 | |
| | *Payout* | 44% | 42% | 37% | 39% | 74% | 47% |
| *SHOES—MANUFACTURING* | | | | | | | |
| International Shoe Co. | *Earnings* | 2.71 | 2.25 | 2.86 | 3.53 | 3.10 | |
| | *Dividends* | 1.80 | 2.10 | 2.40 | 2.40 | 2.40 | |
| | *Payout* | 66% | 93% | 84% | 68% | 77% | 78% |
| *SOAPS & CLEANERS* | | | | | | | |
| Colgate-Palmolive Co.[1, 34] | *Earnings* | 3.10 | 2.74 | 2.60 | 2.01 | 2.25 | |
| | *Dividends* | 1.35 | 1.17 | 1.08 | 1.00 | 1.00 | |
| | *Payout* | 43% | 42% | 42% | 50% | 45% | 44% |
| Procter & Gamble Co. | *Earnings* | 3.96 | 3.55 | 3.40 | 3.05[1] | 2.96 | |
| | *Dividends* | 2.20 | 2.00 | 1.95 | 1.90 | 1.75 | |
| | *Payout* | 56% | 56% | 57% | 62% | 59% | 58% |
| *STEEL & IRON* | | | | | | | |
| Armco Steel Co. | *Earnings* | 5.21 | 3.89 | 4.71 | 6.03 | 6.05 | |
| | *Dividends* | 3.00 | 3.00 | 3.00 | 2.55 | 1.95 | |
| | *Payout* | 58% | 77% | 64% | 42% | 32% | 55% |

| | | *1959* | *1958* | *1957* | *1956* | *1955* | *5-yr. A* |
|---|---|---|---|---|---|---|---|
| Bethlehem Steel Corp. | *Earnings* | 2.44 | 2.91 | 4.13 | 3.83 | 4.52[24] | |
| | *Dividends* | 2.40 | 2.40 | 2.40 | 2.125 | 1.81 | |
| | *Payout* | 98% | 82% | 58% | 56% | 40% | 67% |
| Inland Steel Co.[1] | *Earnings* | 2.58 | 2.77 | 3.45 | 3.14 | 3.17 | |
| | *Dividends* | 1.53 | 1.50 | 1.50 | 1.417 | 1.417 | |
| | *Payout* | 55% | 54% | 43% | 45% | 45% | 48% |
| National Steel Co. | *Earnings* | 7.28 | 4.80 | 6.13 | 7.09 | 6.54 | |
| | *Dividends* | 3.00 | 3.00 | 4.00 | 4.00 | 3.25 | |
| | *Payout* | 41% | 63% | 65% | 56% | 50% | 55% |
| U. S. Steel Corp. | *Earnings* | 4.25 | 5.13 | 7.33 | 6.01 | 6.44[1] | |
| | *Dividends* | 3.00 | 3.00 | 3.00 | 2.60 | 2.15 | |
| | *Payout* | 71% | 58% | 41% | 43% | 33% | 49% |
| Youngstown Sheet & Tube Co. | *Earnings* | 8.90 | 6.23 | 12.35 | 12.62 | 12.34 | |
| | *Dividends* | 5.00 | 5.00 | 5.50 | 4.50 | 4.00 | |
| | *Payout* | 56% | 80% | 45% | 36% | 32% | 50% |
| | | | | | | (Grp. av.) | 54% |
| *SUGAR REFINING* | | | | | | | |
| American Sugar Ref. Co.[1] | *Earnings* | 3.86 | 4.71 | 3.80 | 3.76 | 2.90 | |
| | *Dividends* | 2.20 | 1.85 | 1.625 | 1.81 | 1.19 | |
| | *Payout* | 57% | 39% | 43% | 48% | 41% | 46% |
| *SULPHUR* | | | | | | | |
| Texas Gulf Sulphur Co. | *Earnings* | 1.33 | 1.34 | 1.75 | 2.81 | 3.23 | |
| | *Dividends* | 1.00 | 1.00 | 1.75 | 2.00 | 2.00 | |
| | *Payout* | 75% | 75% | 100% | 71% | 62% | 77% |
| *TEXTILES* | | | | | | | |
| Amer. Viscose Corp. | *Earnings* | 2.98 | 1.36 | 1.65 | 2.93 | 4.66[5] | |
| | *Dividends* | 1.50 | 1.50 | 2.00 | 2.00 | 2.00 | |
| | *Payout* | 50% | 110% | 121% | 68% | 43% | 78% |
| Burlington Indust., Inc. | *Earnings* | 2.72 | 1.21 | 1.64[31] | 1.63[31] | 1.83 | |
| | *Dividends* | 1.00 | 0.70 | 0.85 | 1.00 | 0.80[12] | |
| | *Payout* | 37% | 58% | 52% | 61% | 44% | 50% |
| Cannon Mills Co.[32] | *Earnings* | 5.04 | 5.31 | 6.30 | 5.16 | 4.86 | |
| | *Dividends* | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | |
| | *Payout* | 59% | 57% | 48% | 58% | 62% | 57% |
| Celanese Corp. of America[5] | *Earnings* | 2.44 | 1.64 | 1.55 | 1.66 | 1.45 | |
| | *Dividends* | 0.90 | 0.80 | 0.80 | 0.50 | 0.40 | |
| | *Payout* | 37% | 49% | 52% | 30% | 28% | 39% |
| Stevens (J. P.) & Co., Inc. | *Earnings* | 4.51[19] | 2.60[19] | 2.10 | 2.08 | 2.15 | |
| | *Dividends* | 1.50 | 1.50 | 1.50 | 1.50 | 1.25 | |
| | *Payout* | 33% | 58% | 71% | 72% | 58% | 58% |
| | | | | | | (Grp. av.) | 56% |
| *TIRES, RUBBER & RUBBER GOODS* | | | | | | | |
| General Tire & Rubber Co. | *Earnings* | 4.84 | 2.06 | 2.12 | 2.30 | 2.30 | |
| | *Dividends* | 0.775[12] | 0.70[12] | 0.675[12] | 0.67 | 0.67[12] | |
| | *Payout* | 16% | 34% | 32% | 29% | 29% | 28% |
| Goodrich (B. F.) Co. | *Earnings* | 4.18 | 3.95 | 4.40 | 4.90 | 5.26[1] | |
| | *Dividends* | 2.20 | 2.20 | 2.20 | 2.20 | 1.90 | |
| | *Payout* | 53% | 56% | 50% | 45% | 36% | 48% |

| | | *1959* | *1958* | *1957* | *1956* | *1955* | *5-yr. Av.* |
|---|---|---|---|---|---|---|---|
| Goodyear Tire & Rubber Co.[1] | *Earnings* | 2.29 | 2.03 | 2.04 | 2.01 | 1.97 | |
| | *Dividends* | 0.825 | 0.80[12] | 0.80[12] | 0.80[12] | 0.67 | |
| | *Payout* | 36% | 39% | 39% | 40% | 34% | 38% |
| *TOBACCO PRODUCTS* | | | | | | | |
| Amer. Tobacco Co. | *Earnings* | 9.23 | 8.55 | 8.28 | 7.51 | 7.45 | |
| | *Dividends* | 5.00 | 5.00 | 5.00 | 5.00 | 4.40 | |
| | *Payout* | 54% | 58% | 60% | 67% | 59% | 60% |
| Liggett & Myers Tob. Co. | *Earnings* | 7.28 | 7.60 | 6.85 | 6.39 | 6.46 | |
| | *Dividends* | 5.75 | 5.00 | 5.00 | 5.00 | 4.00 | |
| | *Payout* | 79% | 66% | 73% | 78% | 62% | 72% |
| Reynolds (R. J.) Tob. Co.[1] | *Earnings* | 4.45 | 3.80 | 3.08 | 2.96 | 2.53 | |
| | *Dividends* | 2.10 | 1.85 | 1.65 | 1.55 | 1.30 | |
| | *Payout* | 47% | 49% | 54% | 52% | 52% | 51% |

Included in this exhibit are the 125 companies in Moody's Industrial Stock Average at the end of 1959.

Source of basic data: *Moody's Industrial Manual, 1960.*

Moody's includes some companies in more than one industry classification. In this exhibit, they are shown in only one classification.

[d] deficit

[1] Adjusted for stock splits.

[2] Average for less than five years.

[3] Pro forma, based on average number of combined class A and B common shares outstanding in each period, adj. for 1/5/56 reclassification.

[4] Consolidated.

[5] Adj. for stk divs.

[6] Pro forma to reflect mergers with Haizel-Atlas Glass and Robert Gair.

[7] Includes 19¢ special items.

[8] Pro forma to include Dixie Cup and Marathon Corp.—1955-1956.

[9] Includes non-recurring income 6¢ in 1956, and 15¢ in 1957.

[10] Before non-recurring capital gains of 40¢ a share.

[11] Excludes special credit.

[12] Plus stock dividend.

[13] After non-recurring income.

[14] Includes domestic subsidiaries only.

[15] Consolidated with Pocohontos Fuel Co., excludes $1.68 from sale of assets.

[16] Excludes 49¢ provided for returns.

[17] Includes 83¢ of special income.

[18] After LIFO charge of 36¢.

[19] Includes tax credit.

[20] Includes 34¢ a share non-recurring item.

[21] Pro forma to reflect merger of Best Foods and Corn Products Refining plus consolidating foreign subsidiaries.

[22] Includes credit adjustment.

[23] Includes 24¢ from sale of interest in Plax Corp.

[24] Includes capital gain.

[25] After special charges.

[26] Fiscal year ends March 31 of the following year.

[27] Includes special credit.

[28] After depletion.

[29] Includes 13¢ a share in 1955; $2.26 in 1956; 33¢ in 1957; $4.55 in 1958 and $1.85 in 1959 from sale of assets and adjustment of investments.

[30] Excludes 47¢ from sale of assets.

[31] Excludes capital gain.

[32] Combined common and Class B.

[33] Before special charges.

[34] Includes unremitted foreign earnings.

[35] Fiscal year ends April 30 of the following year.

[36] Fiscal year ends May 31 of the following year.

[37] Pro forma to reflect merger of Union Bag and Camp Paper.

[38] Excludes earnings of car financing subsidiary.

*CHAPTER IV*

# Financing Program

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This chapter discusses the application of some of the principles we have covered. It includes some additional points on setting up a financing program. You may defend the Financial Vice President, if a company's finances get in a jam, by saying, "He may affect profits or losses, but he doesn't make them." True, but he should handle his job so that a financial problem won't arise even if the company encounters difficulties. He should know in advance how he might maneuver. The only way he can accomplish this facility is to:

1. Know all about finance and the related fields.
2. Plan well ahead.

One without the other will do little good.

## PLAN WELL AHEAD

Financial planning requires that you have a forecast of your requirements for outside funds for a number of years ahead, preferably five, and revise it each year, dropping the previous year and adding another. The necessary flexibility in your financing program can be attained only if you have some idea of the magnitude of the requirements a number of years in advance.

It may seem elementary to stress this point, because officials of many companies take for granted making such a forecast; some feel that it is necessary to extend it for more than five years. However, there are others who protest that in their business it is impossible to do so for more than one year. No matter how difficult the task, put down some figures. Three years, and even two, are better than nothing, but unless you can stretch them for at least five, you haven't stepped out as far as you should. You may need to make more than one forecast: a minimum, a maximum and the best estimate somewhere in between. Unexpected large variations cause the greatest strain on financing. The extent to which the nature of your company does make forecasting difficult for five years ahead will, in itself, be a reason for a conservative financial policy so that you will be able to meet unexpected situations.

Good forecasting depends on good budgeting. The year ahead will require a complete operating budget made out in detail. It should be revised each quarter and extended a year ahead. The forecast for years further in the future will have to be done with a broader brush, and does not need to be too precise.

Even in crude forecasting the very act of setting forth certain assumptions as to shipments, prices, costs, etc., over a five-year period will provoke questions. In trying to answer these questions you begin to think about problems which might not be brought to your attention otherwise. Moreover, each time a forecast is made you will find ways of refining it, because, in some cases, you will have found answers or have narrowed your assumptions with greater confidence than previously.

It is important that all of the people who are involved in making estimates of sales, costs, capital requirements, etc., have a clear idea of the purpose of the budget and what its limitations may be. They should know what use will be made of it in order that their own contribution will make the budget a more effective device for planning. If you have difficulty in obtaining the necessary information from your organization, you ought to bring to the attention of your top management the vital necessity of providing it to you so that you can make your plans.

This book in no way attempts to discuss the methods of budgeting; it takes up from the point after the budget has been made. Budgeting is another subject. Therefore, we will not say anything about budgeting methods. For our present purpose, we are interested in the result, which will give us a forecast of the outside requirements for financing. The budget should produce a top summary table which will look something like the following brief form. There will be much careful detail work going into the material that is used in presenting this deceptively simple looking statement.

FORECAST OF FINANCING REQUIREMENTS

| | *Actual Current Year* | *Forecast by Years* | | | | |
|---|---|---|---|---|---|---|
| | | *1st* | *2nd* | *3rd* | *4th* | *5th* |
| Estimated Net Profit after Taxes | | | | | | |
| Less: Dividends (Pfd. and Common) | | | | | | |
| Income after Dividends | | | | | | |
| Plus: Depreciation | | | | | | |
| Plus: Other Items Providing Cash[1] | | | | | | |
| CASH GENERATED INTERNALLY | | | | | | |
| Capital Additions | | | | | | |
| Additional Working Capital | | | | | | |
| Plus: Other Items Requiring Cash[2] | | | | | | |
| CASH REQUIREMENTS | | | | | | |
| Less: CASH GENERATED INTERNALLY | | | | | | |
| FINANCING REQUIREMENTS (excess) | | | | | | |
| FINANCING REQUIREMENTS CUMULATIVE (excess). | | | | | | |

[1] Other items, to be shown separately if large, which provide cash may include: other non-cash items in income statement, proceeds from sale of property, tax refunds, or other non-recurring items, etc.

[2] Other items, to be shown separately if large, which require cash may include: debt retirement, purchase of outside company, purchase of stock for employee stock plan, etc.

A simple table, such as the one above, will be easy for the top management to review and discuss. Naturally, it will be documented by the detailed budget figures, and any other necessary background material.

We have covered the question of dividends in Chapter III. Now it should be apparent why it was taken up early in the book. It is a prerequisite to figuring out a forecast of your financial needs.

## CASH AND WORKING CAPITAL REQUIREMENTS

While we have dismissed the idea of talking about budgeting methods, we will make a few comments about certain items. One item may be particularly puzzling, that is, the proper amount of cash to provide for in your budget. This must include a consideration of your banking relationships. Amounts may be needed for the following purposes:

1. *To carry on regular operations.* How this is estimated will depend on the nature of the company. One possible method is to multiply one-twelfth of annual operating expenses, including taxes and excluding depreciation, by the number of months of your operating cycle. This will have to take into account the collection of receivables. You will wish to observe similar figures for other comparable companies. This, of course, is only a starting point and you will wish to make a detailed study based on the particular circumstances surrounding your company. Some companies look at cash in relation to sales. This ratio may not be very indicative, because cash requirements are generally not as directly related to sales as they are to operations.

2. *To compensate banks for checking activity and other services.* If yours is a company which has a large volume of checking activity, it may be necessary to carry balances in banks in order to compensate the banks for this expense. This is a matter you will have to discuss with them. Services provided by a bank may be much broader than just checking. They may include credit inquiries, custody service, foreign information, economic and financial advice, and other services not directly measurable.

3. *To compensate banks for loan facilities.* Our banking system is based on the principle that, under ordinary circumstances, deposits should bear some relationship to loans, commitments or lines of credit. When banks are short of funds, they naturally have to allocate their funds to those customers which have maintained good deposits. The officers of some companies don't seem to understand and appreciate this idea. They would prefer to pay a higher interest rate and forget the necessity of keeping balances. Without trying to argue the point, it is a fact that our banking system works on the basis of compensating deposit balances, and in order for a company to be able to call on short term funds in an emergency, it must have a good deposit relationship.

A company would be quite remiss in its finance planning if it did not recognize this necessity. It should keep its banks in a frame of mind so that they will be most willing to make loans to the company in an emergency under tight money conditions. For this reason, it is unwise for a company to spread its banking business to so many banks that it is unable to keep satisfactory balances in any of them. It will naturally wish to favor local banks, and should do so. However, if local banks do not have adequate loan capacity to take care of a company's needs, that company should spread its cash balances to its larger bank or banks outside its territory so that it will be able to obtain sufficient credit.

During tight money conditions, some banks may be hesitant to lend their full legal limit to any one customer because of their desire to spread available funds around to satisfy all customers. Therefore, as a rough rule of thumb, a company might consider having sufficient banks so that if each loaned 80% of its legal limit, they would in total be able to provide the company's maximum requirements. This, of course, depends on the relationship which a company maintains with its banks.

These items are not necessarily additive, and one may be so dominant that no other allowance for cash need be made. In connection with bank balances, the corporate treasurer ought to be aware of the difference between the bank statement and the bank registered balances. For large companies, float, that is checks drawn on a bank not yet received by the bank, may make for a substantial difference in the two statements. There is an increasing use of cash controls to speed the flow of cash and reduce transit time both in mail and clearing, thereby reducing minimum cash needs. In the end, the nature of a particular company will determine the importance of cash. The maturity of a company will have an effect. A new enterprise will need more cash because it will have less facts available on which to determine its exact needs. Furthermore, there may be unforeseen demands which may arise because of the inability to get into production on a profitable basis. Conservative management would at least try to provide enough cash, or access to credit, to see the enterprise through the most adverse periods.

There are other tests which may be used by some companies for cash and cash items, such as short-term governments equivalent to the tax liability, and cash equivalent items equal to current liabilities. The final result for each company will reflect to some degree the nature of the personality handling the matter, that is, the extent to which he pursues conservatism. The final answer can only be established within certain limits rather than as an exact figure. However, a company cannot go too far outside feasible limits, in either direction, without penalizing itself in one way or another.

An additional word should be mentioned in regard to cash items such as short-term governments. Allowance may be made for the need of additional cash for contingencies, seasonal or cyclical swings, etc. Depending on the nature of these needs, they might be taken care of by bank loans. However, large companies will generally not run the cash and cash items down to a bare minimum. They will want some liquid reserves. Cash for these purposes will be invested in securities, the equivalent of cash. A company is asking for trouble if it tries to be too smart in investing such items in order to make a little extra income, as, for example, by investing in long rather than short maturities. If interest rates increase so that bond prices fall, the investment in long maturities becomes frozen, unless the company is willing to take a loss. The maturities for such investments should not exceed the time when the funds may be needed. And a company should shy away from special types of investments which are not in all respects the equivalent of cash.

Next, we will say a word about working capital, part of which is accounted for by the cash item just discussed. Working capital for some companies may be a larger item than the plant itself. It may appear that we are getting off the track of our subject, long-term financing. Perhaps so, but working capital and current ratio may have effects upon the quality of a company's long-term securities. Some bond indentures and term loan agreements require that a company maintain a certain minimum working capital or current ratio as a control. There seems to be a difference of opinion of how much weight is given by the rating agencies to current position in determining bond ratings, but its possible importance should not be overlooked. Some buyers of senior securities feel that current ratio is an important indication as to the soundness of a company's financial policies. Banks analyze current position (present and projected) carefully in their credit analysis of a company. A company which tries to get along with too little working capital, and overuses its short-term credit facilities, may show a lack of understanding of a sound financial approach. Don't forget to include an adequate amount of additional working capital for any new plant.

Of course, the real problem is to arrive at the optimum working capital for your company; this is the amount that will provide the proper balance between the minimum necessary to support the company's operations and the maximum for complete safety to creditors. In arriving at what the desirable ratio should be, figures of competitors and industry leaders are important, since creditors will give considerable weight to your position as compared with others in your industry in analyzing your financial condition. If your figures vary substantially from the industry figures, you will wish to have good reasons to explain the difference.

## SETTING UP A FINANCING PROGRAM

Your company may need to raise only a small amount of money, or a large amount in only one out of five years. Then the mechanics of setting up a financing plan are easy. However, if fairly large amounts are required in each year for a number of years, the mechanics become similar to fitting a square peg in a round hole. It can be simplified, if done in rough form, in two steps. After having established the appropriate capital structure ratios, the first step is to determine the total amount of each type of long-term security which will have to be sold in the five years to achieve the appropriate capital structure ratios at the end of the period. The second step involves breaking up the amounts of each security to be sold each year.

CAPITAL STRUCTURE

(000,000 omitted)

| *Capital Structure* | *Beginning* | | *Retained Earnings* | *New Issues* | | *End of 5th Year* | |
|---|---|---|---|---|---|---|---|
| Debt | $40.0 | | | $14.0 | | $54.0 | |
| % of total | | 20% | | | 28% | | 20% |
| Preferred | 20.0 | | | 7.0 | | 27.0 | |
| % of total | | 10 | | | 14 | | 10 |
| Common | 140.0 | | $20.0 | 29.0 | | 189.0 | |
| % of total | | 70 | | | 58 | | 70 |
| Total | 200.0 | 100 | 20.0 | 50.0 | 100 | 270.0 | 100 |

The whole process can be handled in one large spread sheet with a number of columns, but for purposes of explanation we will break it down into three tables. Let's assume that the bottom line of our previous table (pg. 77), showed financing requirements to be as follows:

(000,000 omitted)

| *1st Year* | *2nd Year* | *3rd Year* | *4th Year* | *5th Year* | *Total* |
|---|---|---|---|---|---|
| $10.0 | $5.0 | $20.0 | $5.0 | $10.0 | $50.0 |

We will assume that the capital structure of our company at the beginning of the first year is as set forth above, and that this type of structure is a satisfactory goal for our company based on the considerations discussed in Chapter II. Therefore, during the five-year period we will plan to sell securities so that the ratios at the end will be the same as at the beginning. In figuring the capital structure ratios, we will have to allow for the fact that earned surplus will increase because of retained earnings. In our previous table, in the item "Income after Dividends," we have already allowed for the cash that the company will generate. We will assume that retained earnings will amount to $4,000,000 annually, or $20,000,000 at the end of five years. This will have to be added to the common equity in figuring the ratios.

As a second step, we have to decide on the amounts of each security to sell each year in order to raise the approximate capital required in each year, keep the capital structure ratios from getting too far out of line in any one year, and offer securities in amounts neither too small nor too large. One plan might be as shown on the next page.

After you have set up such a rough plan, you will have to refine your figures, because the additional charges, etc., on the proposed securities will need to be included in a revised budget. Also, in order to provide interim cash, pending long-term financing, you may have to include a temporary bank loan.

## USE OF BANK LOANS PENDING LONG-TERM FINANCING

Bank loans should add to flexibility and not detract from it, as may occur if you stretch their use too far. Under ordinary circumstances, you should not plan to use bank borrowings for expansion purposes up to the maximum, either of length of time or amount, before refunding them with long-term financing. The savings from the use of short-term bank loans in order to postpone perma-

| | *1st Year* | | *2nd Year* | | *3rd Year* | | *4th Year* | | *5th Year* | |
|---|---|---|---|---|---|---|---|---|---|---|
| *Sales of Securities* | | | | | | | | | | |
| Debt | $— | | — | | $14.0 | | — | | — | |
| Preferred | — | | — | | 7.0 | | — | | — | |
| Common | 14.0 | | — | | — | | — | | 15.0 | |
| | $14.0 | | — | | $21.0 | | — | | $15.0 | |
| *Resulting Capital Structure* | | | | | | | | | | |
| Debt | $40.0 | | $40.0 | | $54.0 | | $54.0 | | $54.0 | |
| % of total | | 18% | | 18% | | 22% | | 21% | | 20% |
| Preferred | 20.0 | | 20.0 | | 27.0 | | 27.0 | | 27.0 | |
| % of total | | 9 | | 9 | | 11 | | 11 | | 10 |
| Common | 154.0 | | 154.0 | | 154.0 | | 154.0 | | 169.0 | |
| Retained Earnings | 4.0 | | 8.0 | | 12.0 | | 16.0 | | 20.0 | |
| % of total | | 73 | | 73 | | 67 | | 68 | | 70 |
| | 218.0 | 100 | 222.0 | 100 | 247.0 | 100 | 251.0 | 100 | 270.0 | 100 |

nent financing may seem quite large in terms of dollars for a year or two. However, such savings must be weighed in relation to the possible higher cost over a long period of time on long-term securities.

The advisability of using short-term bank loans and postponing the sale of long-term securities until a construction program is completed, depends on all the surrounding circumstances at the time of the contemplated financing, including market conditions and a company's situation.

If conditions improve, an increase in security prices will naturally result. On the other hand, if conditions are favorable at the start of the construction program and adverse developments occur subsequently, there may be a decrease in the prices at which securities can be sold. Also, a change may occur in the type of terms of the securities that can be arranged. Severe deterioration in the market could prevent the sale of certain types of securities.

The following simple example will illustrate how any savings that might be realized through short-term loans could be lost, if there were a relatively small drop in the market for long-term securities.

Assume that a company wishes to raise $6,000,000 for expansion purposes, that the construction will be done over a one-year period, and that at the end of the year permanent securities will be sold to retire the short-term loan. With a short-term bank loan interest rate of 5%, and with $1,500,000 borrowed each quarter to meet construction needs, the interest cost would be as follows:

| | |
|---|---|
| $1,500,000 @ 5% for 3 mos. | $18,750 |
| 3,000,000 @ 5% for 3 mos. | 37,500 |
| 4,500,000 @ 5% for 3 mos. | 56,250 |
| 6,000,000 @ 5% for 3 mos. | 75,000 |
| | $187,500 |

We will test the possible savings by use of temporary bank loans, as contrasted with three possible means of raising $6,000,000 through the sale of long-term securities at the start of the year:

1. Bonds with 30-year maturity and a 5% interest rate, sold at a net price of 100 to the company.
2. Preferred stock with 5½% dividend rate, sold at a net price of $100 per share to the company.
3. Common stock with a $1.10 dividend rate, sold at a net price to the company of $18 per share, or 333,333 shares.

The relative savings from the use of short-term bank loans for one year, on the basis given above, and postponing permanent financing for one year, would be as follows, assuming a 50% tax rate:

| | |
|---|---|
| 1. Savings over Use of Bonds | |
| Bond Cost, 1 year | $300,000 |
| Bank Loan Cost, 1 year | 187,500 |
| Difference | $112,500 |
| Net Cost after Taxes | 56,250 |
| 2. Savings over Use of Preferred | |
| Dividends on Preferred 1 year | $330,000 |
| Bank Loan Cost 1 Year, Less Tax Savings | 93,750 |
| Net Cost | $236,250 |
| 3. Cash Savings over Use of Common Stock | |
| Dividends on Common | $366,667 |
| Bank Loan Cost 1 Year, Less Tax Savings | 93,750 |
| Net Cost | $272,917 |

All of the above savings would be used up if long-term security prices fell the following amounts during the year that the permanent financing was postponed:

1. Bonds would have to fall 0.94 in price (from 100 to 99.06), or a change in yield of only 0.06% from 5.00% to 5.06%.
2. Preferred stocks would have to fall $3.94 in price (from $100 to $96.06), or a change in yield of 0.23% from 5.50% to 5.73%.
3. The net price the company received from common stock would only have to fall from $18.00 to $17.18, less than $1, or an increase in yield from 6.11% to 6.40%.

In order to appreciate the significance of these figures, they should be compared with the size of the actual market fluctuations of security prices and yields over a period of 6 months to a year. For example, Moody's average yields for *Aaa* outstanding issues of industrial bonds (see Chapter II for table on yields) increased from 3.61% in 1958 to 4.27% in 1959, or 0.66%. Of course, the savings through the use of bank loans will vary, depending on the relationship of the bank rate and the rate on long-term securities.

No allowance is made in these figures for the fact that if long-term financing is done immediately, the excess cash could be invested in short-term government securities, so that the apparent advantage of bank loans would be even further reduced.

The above remarks could be interpreted as suggesting that bank loans should be used primarily to assist in picking the very best market for the sale of long-term securities. Subsequent remarks will indicate that this would be a wrong interpretation. The approach indicated above is merely for the purpose of placing the cost factor in the proper perspective. The essential point is to avoid inflexibility.

When term bank loans are used, alternate methods of repayment under varying circumstances should be worked out before the loan is made. This is one of the major factors in evaluating the advisability of using such a loan. A good five-year financing program will include such a consideration.

You will need to test your financing plan or plans to see how they meet many other objectives, which we will now discuss.

## TEST PLAN IN TERMS OF GOOD, AVERAGE AND POOR EARNINGS

You should make some estimate as to what you consider good, average and poor earnings for your company and test the final financing program under each of these conditions. Include earnings coverage figures for senior securities, and the earnings per share for the common, as well as the dividend payout ratio. A similar type of test should be made with the cash budget, including any sinking funds on proposed new securities and coverage of total debt service. This will help you visualize whether your program will stand up under adversity and whether it has the necessary flexibility. If poor earnings indicate the likelihood that certain sinking fund conditions may not be met, the whole program should be carefully reviewed as to the magnitude and nature of the undertaking.

With adverse earnings you may need to resort to debt financing and postpone the scheduled sale of common or preferred. You should see how the use of debt would affect the financial strength of your company and how you would again restore the borrowing reserve. For example, see what would happen if you were forced into all debt financing for a period of three years.

## STUDY FUTURE MATURITY AND SINKING FUNDS

Any sinking fund or maturity within the period of the budget will show up in the budget itself; however, sinking fund payments and maturities after five years will have to be reviewed in addition. They may have a bearing on how the program is arranged within the five years. You should observe carefully the burden that these may entail. Sinking funds on existing debt may affect the design of sinking funds on new securities.

In setting the maturity of new debt issues, it is advisable to space maturities so that excessively large amounts do not fall due in a short period of time. If you have a large maturity after five years and your company is in a weak financial position, you may find it necessary to include as part of your five-year plan some program for reduction of that debt ahead of maturity or setting aside of cash to assist in repayments.

Evaluation of these problems, subsequent to the budget period, will have to be on the basis of judgment. You should ask yourself how later maturities and terms of senior obligations, etc., would be handled if they were present today, under trying conditions. Would they be likely to present difficulties? Your financing program should be planned to anticipate such eventualities.

## SIZE OF COMMON OFFERING

The ratio of common equity to total capital structure should be kept adequate and improved gradually if out of line. But in planning common stock financing care should be taken, as far as possible, not to depress the market price. Here are a few principles to keep in mind. Don't make a single offering too large so that there is excessive dilution. A 1-for-10 offering will mean a 10% decrease in earnings per share until earnings on the new investment materialize. There are examples of much larger proportionate offerings, such as 1-for-4, but that would mean an immediate 25% dilution of earnings, which is rather severe. While offerings should not be too large relative to the outstanding shares, nevertheless, too many small offerings strung out over a period of time increase financing costs and may also have a continuing depressing effect on the market.

As was pointed out in Chapter III on Dividend Policy, common stock financing will have an effect on dividend payout ratio, and on earned surplus per share. Deciding on the right size and spacing of common stock offerings is a matter of judging the correct balance between the condition of the common stock market and the company's earnings outlook. A favorable market may suggest a step up in the size of the offering. The same applies when the earnings outlook is good, because the dilution in earnings per share will be lessened by the improvement. In fact, if your financing program will permit, you may be able to time your common offering when earnings per share are expected to bulge, in order to offset the dilution. Your aim should be to have a gradual, steady increase in your earnings per share.

## TIMING OF FINANCING

When it comes actually to selling a security, the general market condition for securities will have to be taken into account. The market's condition may affect the type of security your company will offer, it may require special terms in a security in order to attract buyers and it will govern the price. More specifically, you will have to decide whether you should sell the security now or wait until later on. This will be dependent to some extent upon the urgency with which your company needs cash, but it may also be affected by the condition of the securities markets. Answer this question at an early date, because you don't want to go to the bother and expense of setting the machinery of finance in motion if the answer is to wait. If you do go ahead and the market changes, you will have to review the situation again just before the offering date.

There are certain rules which are worth keeping in mind in your efforts to make this decision. Obviously, you should avoid selling a security in a distressed securities market, but when capital is needed and the securities market is reasonably favorable, it is unwise to try to be too smart and outguess the market. By outguessing the market is meant trying to select a specific time, during a 12-months period, for example, when the market will be most receptive. The best of economists cannot forecast interest rates and the stock market with any degree of certainty. Underwriters learn their limitations in forecasting by the losses they incur if they fail to accept their limitations. And company officials should not plan their new money financing on the assumption that they can do more than try to avoid adverse markets. So the best rule might be: when you need capital, get it, if the securities markets are receptive. Refunding of outstanding issues may require more emphasis on trying to guess the outlook for the market. The reason for this will be pointed out later when the subject is discussed.

If you have both common stock and bonds to sell within a relatively short period, it is generally best to sell the common first. This adds to the equity ratio and improves the debt picture. Furthermore, it saves the easiest security to sell to the last, in case an adverse stock market is encountered. Prevailing market conditions for the two types of securities will, of course, affect this decision.

When you decide to go ahead with your financing, you will have to pick the day for the sale in order to establish a time schedule. If you offer securities competitively, you will be interested in the best day of the week for the bidding day. The choice is largely the result of the preference of the underwriters. They are not unanimous, but some prefer Tuesday and Wednesday. The underwriters can take a last-minute look at the market on Monday to see if anything happening over the weekend had any effect on the market. They can have their preliminary pricing meeting the day before the bidding without having a weekend intervene. Actually, Monday does not have serious drawbacks, but Tuesdays or Wednesdays are preferred. Friday is considered a bad day because underwriters do not like to take the risk of carrying the issue over the weekend. Thursday is not bad, but has some disadvantage because it is close to the weekend. Watch out for local holidays in areas where a large potential demand for your securities may exist.

A calendar of forthcoming issues should be consulted in order to avoid congestion and conflicts. Congestion will ensue whenever an excessive number of similar typed issues is offered during a short period of time, such as a month or quarter. If there is a flood of issues, the buyers may use up those funds immediately available for investment; the underwriters may accumulate a large inventory of unsold issues—which will detract from their eagerness to take on more. During periods of adverse change, buyers will be reluctant to purchase at a price which may prove too high tomorrow or next week.

Conflicts will occur whenever more than one similar type of issue is being offered on the same day at the same time. The problem of conflicts occurs mostly in competitive bidding. If there are conflicts, the buyers are in a more advantageous position since they can pick and choose between issues being simultaneously offered. Furthermore, the underwriters may be less anxious to stick their necks out if they have the opportunity to handle more than one issue at a time. In calculating their risk, underwriters bidding on more than one issue have to assume that they will get all of them. If it is impossible to pick a day on which no other similar issue is to be offered, at least an hour should be chosen when there is no other issue. A bidding should not be before 10:30, because underwriters must have time for their final price meeting before the bidding. It should be before 2:00 P.M.[1] so that the price, etc., can be filed with the Securities and Exchange Commission to permit selling to start as soon as possible. You will be able to find someone in a large financial institution who keeps informed of forthcoming issues and will be glad to advise you.

If senior securities are being sold which will be purchased by institutional investors, the summer vacations represent no real disadvantage. Institutional investors cannot let money lie idle merely because someone is on vacation. For common stocks which are sold to many small investors, there might be reason to avoid the vacation period. A few special types of institutional buyers may have larger accumulations of cash at certain times during the year, and at other times may be out of the market. If an issue must rely on such special buyers as the primary market, the sale may be timed when they are most flush. This is a rather unusual situation.

## TEAM PLAY WITH THE EXPERTS

The Financial Vice President should call the shots and run the show in financing—not an outside lawyer, underwriting firm, or advisor. However, he cannot be expected to know all the answers and he should not hesitate to rely on experts. There are four principal experts in the sale of a security—the lawyer, the underwriting firm if one is used, the tax expert, and the accountant. The Financial Vice President may be knowledgeable in one or two of these fields, but it would be unlikely that he would be qualified to give the final word in all of them. He should run the operation on a team basis in order to assure best results.

There are two lawyers, the company's own house lawyer and outside counsel. Security work is a very specialized field. The pattern changes and new and valuable legal provisions on securities, etc., are constantly being developed. The lawyers located in the large financial centers may not be any smarter than lawyers in small communities, but the fact is that because they are constantly working on financing, they keep up on and hear about new ideas in their field. These may be worth much to a company. When you choose outside counsel you will do well to weigh the importance of having a top financial lawyer on your team. Bond indentures are seldom a matter of routine. It should be your hope to get a lawyer who can make financial law really live and who is on his toes for new ideas which will make your financing easy to live with.

In establishing a financial program, it may be important to have the lawyers consider its effect on the legality of the securities for some types of institutional purchasers.[2] It may not be possible to vary an entire program to fit into the pattern of the requirements of such purchasers, but in certain instances, a small change may be made so as to conform to the legal provisions. If a company's securities have previously been legal for certain purchasers, it is even more important to have this in mind, so that they will not be disturbed by a change in the legality.

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[1] Some underwriting firms prefer competitive bid offerings of common stock after the close of the market on the exchange.

[2] As an example of legal provisions there are briefly summarized below some of the provisions in New York State Banking Law (Section 235) for savings banks:

Mortgage Bonds—Electric and Gas Companies (Subdivision 13)

1. Capital stock (including preferred and common), premium and surplus must be at least ⅔ of debt secured by a mortgage.
2. Mortgage indebtedness should not exceed ⅔ of net plant.
3. Net earnings should have averaged in the past fiscal 5 years 2½ times the average annual interest charges applicable to period.
4. Net earnings in past year should at least equal 2 times annual interest charges on debt outstanding at time of investment.

Preferred Stocks—All Industries (Subdivision 26, a.)

1. Net earnings after Federal and state income taxes should average over the past 5 years at least 1½ times annual fixed charges and preferred dividend requirements as of the date of investment.
2. Net earnings in either of the past 2 years should at least be 1½ times annual fixed charges and preferred dividend requirements for that year.

Common Stocks—All Industries (Subdivision 26, c.)

1. They must be registered on a national exchange.
2. They must have paid cash dividends on the common stock consecutively for the past ten years.
3. They must have earned in the aggregate dividends paid over the last 10 years.
4. Preferred stock, if any, must be a legal investment for savings banks.

In some financial moves, the accounting treatment may turn out to be something you do not like. Be sure you find out from your controller how it may look in published statements. This may also involve your outside auditors. It might be pointed out here that your accountants should be aware of the effect of accounting changes on finance. For example, as just pointed out, some of the tests to determine the legality of investments for some institutions are defined in terms of certain accounts. Bookkeeping changes have resulted in the legal status of securities of a company being lost, when the effect of accounting changes has been disregarded.

Then there is your tax expert. In the introduction, the importance of the effect of taxes on financing was discussed. It was pointed out that, if this book covered all the possible tax angles of long term financing, it would be excessively long and complicated. However, it naturally assumes that a company will weigh every possible tax effect for all alternate sound methods of financing.

The Financial Vice President and his counsel should prepare a schedule in detail of each step to be taken, with assignment of responsibilities, for each participant. Above all, get the team working together at the start of the financing. This will keep down expenses and prevent steps being taken which the experts cannot later rectify, or which can be changed only at substantial cost to the company.

*CHAPTER V*

# Types of Securities

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In the second chapter, on capital structure, securities were divided into debt, preferred, and common equity. In the last chapter, "Setting Up a Financing Program," we still did our rough planning with these three types. There are numerous kinds of securities within these classifications. Since we are approaching the point of selling securities we will have to be more specific. We will now consider some of the various kinds.

What will this chapter do for you? It will sort out, in some orderly fashion, the principal media of financing, some of which are not strictly securities. Its purpose is to give you a bird's-eye view, in order to help you sit back and view the media in broad perspective and to make a sound choice. Also, it will cover some ideas about the principal terms. Where feasible, advantages and disadvantages of types of securities will be briefly listed. Much of the material will be presented in outline form.

Undoubtedly, you realize that the chapter will not give you a description of every possible security, or a form to follow in setting up all the terms that might be included in a particular security. The many terms can be varied in so many ways as to create an almost infinite shading of securities. Furthermore, the terms of a single bond issue alone may require more space than this chapter. To cover all the provisions of all types of securities would be impossible, and boring as well.

You may know much of what is included here, but perhaps you have not kept up on all the various securities recently. In that event, it will help you review quickly the pros and cons that you will have to weigh in making a decision and that you may have to explain to others in your company. The headings in the chapter will help you skip around to the material in which you are most interested. Two controversial media are lease financing and convertible issues. They are treated in more detail because of their complexity. If you have ever had a chance to view the entire financial community and have seen the many varieties of opinions on such subjects as types of security to use, I would emphasize the fact that, in the last analysis, you must rely on your own judgment for the final decision. Whatever your choice, you will wish to have a good answer as to why, and why not, for possible alternatives. If you find that this chapter is not enough for your purpose, it should at least speed up the analysis of your company's problem.

## AIMS OF COMPANY AND THE INVESTOR

There are two parties ultimately involved in a security transaction, the company and the investor. An investment banker may intervene as the intermediate purchaser before the security is distributed to the investor. Also, in a debt issue there may be a trustee whose function is to hold title to property and see that the provisions of the security are met for all the holders.

Whether or not the investor purchases directly from the company or through an investment banker, each party, the company and ultimately the investor, is attempting to obtain the most for his money in a very competitive market. For senior issues, the investor wants as much income as possible and terms which will provide as much security of principal as possible. The company wants to pay as little as possible and have what might be called loose terms. It wants freedom of action regarding use of assets and sale of other securities to raise capital.

During negotiations for the sale of a security it is to be expected that neither party may seem entirely reasonable to the other, since the company and the investor are seeking the best deal for themselves. However, it should be far from a cat and dog fight. There should be an appreciation by both parties of the justification of a common sense balance.

The company should not agree to unnecessary limiting provisions, particularly those which will hobble it in the future. Nevertheless, it should accept the fact that many provisions are highly necessary for the investor and it should be freely willing to accept them. This particularly applies to those provisions which the company should realize are mutually beneficial. Some provisions work to the company's advantage, although they may not seem to do so. For example, a sinking fund helps restore a company's credit by debt reduction.

Certain investors may take the approach that the more restrictive provisions they can get, the better. This is not practiced by the majority of far-seeing large institutional investors. They should have as much interest as the company itself in keeping the company flexible and able to finance so that it will remain financially healthy. If both parties know what they are doing, each gets what he pays for. If you push your finger into a balloon, its effect must show up somewhere and the same idea applies to securities and their terms. Always consider carefully all the advantages and disadvantages.

No instrument of a long-term security will fully protect it unless the enterprise continues to be successful. Within this limitation, what is the investor in senior securities trying to achieve by the terms? He, in essence, wants to be sure of payment of income and principal. Payment of principal of a debt security can come only from cash generated by operations in one way or another, or refinancing, or liquidation of assets. If refinancing has to be relied upon for repayment of a debt obligation, there may be an added uncertainty where the maturity is far in the future.

As previously pointed out, the investor is interested in more than just payment of principal. If he decides to sell the security before maturity, he will wish to have the market price maintained. It will be affected by the extent of protection. The following comment by a representative of a large institution emphasizes this point: "My firm recently had a 10% market loss in its investment in the bonds of a company when the bond rating was lowered a notch due to adverse developments. The loss amounted to millions of dollars. Therefore, we do have a direct interest in the maintenance of a company's credit."

## TYPES OF SECURITIES

Why are there so many varieties of securities? There must be, of course, some common stock. It represents the ownership and has the major risk. The reason for the great variety of securities: to fit the nature and needs of different types of companies and the different desires of investors at a particular time. Special characteristics of some companies call for special securities. One type of security with all its features will fit some investors' needs, another type will appeal to others, depending on existing circumstances.

You will wish to compare the cost and terms of one security with another. When you do, you will come up with some erroneous results if you do not correctly distinguish the security by the three broad types. You will be comparing oranges and apples without recognizing their differences. Any kind of debt is quite different from either of the equities—preferred and common—and within the equity family, preferred is different from common.

You undoubtedly have in mind your own definitions for the three basic types. If there were not an almost unlimited variety within these types, there would be little occasion for saying anything about them. However, for future reference, it will be helpful to start off with an explanation of them. Note that we do not use the word definition, but rather explanation. It is for the purpose of assisting in understanding rather than being all-inclusive and limiting, as a complete definition should be.

1. *Debt*—a form of obligation to pay an amount of principal, and to pay interest or the equivalent upon such principal until it is repaid. The payments may be combined together, but no matter how stated, these two parts are present. If they are not paid, rights accrue to the holder of the obligation regarding either one or both of the following: the enforcement of a claim to the general funds of the company ahead of equity securities; the enforcement of a claim to specific property or income pledged as collateral.
2. *Preferred stock*—in all respects junior to debt obligations. Non-payment will not permit enforcement of debt type of claim. Within the limits provided in the preferred stock terms, the company can issue debt ahead of the preferred. It provides protection for debt. When there is non-payment of dividends for a certain period, some of the common stock privileges may accrue to the preferred stock.
3. *Common stock*—represents the ownership. It takes the ultimate risk, and comes after all senior securities.

There is given below the order which the discussion of media of financing will take. We start with some explanation and definitions and then proceed from the most towards the least secure. Convertible securities and warrants may seem out of place as far as security is concerned. The reason for the order will be apparent as we go along.

- Debt Securities
  - Secured
    - Mortgage financing for real estate
    - Mortgage bonds
    - Equipment trust certificates
    - Lease financing
  - Unsecured
    - Debentures
    - Long term notes
    - Term bank loans
    - Income debentures
  - Other forms of debt financing
  - Preferred Stocks
  - Convertible Securities
  - Warrants
  - Common Stock

In selecting a particular security for your company, you should have the following points in mind, in addition to what was said in Chapter II, "Capital Structure":

1. Its cost—meaning yield to maturity for debt and current yield for preferred. You will find these yields explained in the next chapter, "Selling Senior Securities." Your calculations should take into account the expenses of financing.
2. The terms—which should be looked upon as part of the cost.
3. The strategic position, as to assets and earnings, that the claim for payments of principal and income may occupy in relation to existing securities and possible future issues.
4. The immediate effects of the security on the other securities in the capital structure.
5. The effects of the security on future financing.
6. The expense of the instrument, such as a mortgage, to create and service the issue.

## GENERAL COMMENTS ABOUT TERMS

Some of the terms of senior securities are included for the purpose of maintaining a company's credit standing. They are the bare minimum boundary lines established by buyers of securities. They may be expressed in ratios used in security analysis. One astute buyer of securities suggested that such terms might be compared with three other standards as follows:

> *Security analysis*—a thorough qualitative analysis made by an expert based on all ratios and factors affecting a company.
>
> *Ratings by Fitch, Moody's and Standard*—the final credit judgment about a company, arrived at through security analysis.
>
> *State laws defining the legality of securities for investment by certain institutional investors*—the bare minimum boundary lines for a security just to qualify for investment by such institutions.

This comparison brings out how some of the provisions of securities are economic in nature. In evaluating terms, have in mind what one is attempting to achieve for the protection of the investor and compare them with standards of good credit. The extent and complexity of the restrictive terms depends on the credit standing of a company, the nature of the business and the newness of the type of financing. New ventures by companies with no previous credit standing may necessitate more detailed provisions. Credit terms may be affected by money market conditions, and by regulation for types of companies which are subject thereto.

Unfortunately, most terms of securities are expressed in a complicated way. This is due partly to the nature of the animal. The wording is an endeavor to encompass all conditions that might arise over a period of many years. They must be so worded that they cannot be misinterpreted to permit the company to do things, later on, under changed circumstances not presently apparent. The situation is compounded where an old existing instrument for a security has been added to and modified over a period of years with subsequent financing. Complication is due partly to the fact that the persons who draft the instruments may not be willing to take the time to unravel the mess to make it easily understood. At the time a security is sold, everyone is rushing to meet a deadline and the only aim is to complete the paper work. The form it takes is secondary. It is refreshing to come across wording once in a while which shows that an effort was made to increase understandability. Complication should not be the aim. It adds to the difficulty of understanding on the part of the investor. This may add to the risk in the investor's mind and the cost to raise the capital. Simplicity in securities is worth a try.

When deciding on what terms to include in your security, it will be helpful to make an analysis of all the terms of securities of a similar nature recently offered by comparable companies. You probably have to rely on public offerings because very little of such information is available on private sales. Refer to prospectuses for some of the principal features, but probably you will wish to obtain more comprehensive information about some offerings. It will be found in registration statements, original Listing Statements, Forms 10K, indentures, etc. Just as a reminder when you are considering the terms, some do's and don'ts follow:

> *Don't* consider that just because a term has been included in a certain way in the past that it has to be repeated, especially if it is unsound. If the market or buyers require your repeating such a term, you have to do so, but if it does not correctly serve a function, you should not hesitate in trying to change it.
>
> *Do* look upon terms of your securities as very important. They may turn out to be a tight noose around your company's neck, if you failed to think of all their possible effects under different circumstances when you set them up. Your company must be able to run its affairs so as to have flexibility within the iron fence imposed by the terms. Evaluate each of them as though they applied today under trying conditions, including the maturity of debt and even the default provisions which may seem quite remote.
>
> *Do* understand that sound terms should be good for you as well as for the investors. Try to express them so that they are reasonably intelligible. In this connection, choose a lawyer who is not only an expert in this field and can think in terms of economics rather than purely legal framework, but who in addition has a sincere interest in making his writing understandable. Give him time to achieve this goal.

## DEBT SECURITIES

Before we start on specific types of debt issues, we will discuss some ideas which might be helpful in understanding them, and some provisions which apply to most types. If you have had some experience in this field you can skip the items which are old hat to you.

### *Definitions, the Trustee, Forms of Bonds and the Trust Indenture Act*

Funded debt, which is the type of debt we will be talking about, refers to debt with a maturity longer than one year. The other type of debt is current, short-term or floating debt with a maturity of a year or less and included in current liabilities.

A bond is a certificate stating the amount of debt that the particular bond evidences. The legend or wording on the bond includes a few terms and refers to the indenture, which is a separate legal document giving the complete terms of the bond issue. A bond must be properly dressed up—fully engraved or printed on steel engraved borders.

The word indenture is defined in the dictionary as an agreement in writing, or a formal document. It is likewise given broad meaning in the Trust Indenture Act. There the term is stated to mean "any mortgage, deed of trust, trust or other indenture, or similar instrument or agreement . . . under which securities are outstanding or to be issued." The provisions in an indenture are known as a covenant, which means a contract, a promise, a pledge.

It would be impractical in a bond issue held by a number of investors for each one to have to see that all the terms of the indenture are fulfilled by the company. In order to solve this problem, a trustee may be appointed who acts for all bondholders. When there is a trustee, the indenture is a contract between the issuing corporation and the trustee. The holders of the bonds have a right to participate in the indenture, and it is administered by the trustee for the benefit of the bondholders. There may be more than one trustee, but there need not be. The Trust Indenture Act requires that at least one trustee shall be a corporation authorized by law to exercise corporate trust powers and be subject to regulation.

A bond may be secured by a mortgage. Such a bond has assets pledged as a security and has a lien on those assets. A mortgage bond may require three documents: the bond, the indenture giving the terms of the issue and the mortgage which covers the pledged property. The latter two may be combined in some instances. A debenture bond is an unsecured bond and, therefore, there are only two documents: the bond and the indenture.

A bond can be a coupon bond, a registered bond, or registered as to principal with coupons.

A coupon bond has coupons attached to it—one for each date on which interest is due. The holder may send the appropriate coupon to the paying agent; a check is remitted for the interest. Also, coupons may be collected through banks in much the same fashion as a check. This is how the picture of the wealthy man clipping coupons originated. Coupon bonds are generally in $1,000 denominations, or a few multiples thereof. It is a bearer instrument and as such is negotiable and transferable without any registrar intervening. Anyone can collect the interest by sending in the coupon when due. A coupon bond may be registered, but it need not be. If it is registered, then the principal or face is non-negotiable, although the coupons will remain so.

A fully registered bond does not have coupons attached, but contains a statement of the rate of interest and dates when due. It is non-negotiable. When such a bond is sold by one investor to another, it must be sent to the registrar for the bonds—who keeps track of the owner and his address and sends the interest to the person in whose name the bonds are registered. The registrar gives a single bond to each investor, generally in multiples of $1,000, representing in one piece the total principal amount of bonds he owns. Transfer of a registered bond is handled in a similar way as transfer of a share of stock.

The usual practice today is to provide for two forms of bonds for a single issue. For example, bonds may be in the form of coupon bonds in the denominations of $1,000 registered as to principal only with coupons attached, and in fully registered form in denominations of $1,000 or any multiples thereof. These two forms are interchangeable as provided in the indenture, upon payment of a small charge, which may not exceed $2.00 per certificate. However, a company usually will make such exchange without charge in order to convenience original purchasers of a new issue, and may do so subsequently as a matter of policy.

The small investors may prefer coupon bonds because they are easily transferable without going through a registrar. Institutional investors with large holdings prefer registered bonds because it reduces the amount of paper that has to be in safekeeping. Today, non-convertible bonds are bought mostly by institutional investors and the majority of such newly issued bonds are in registered form. There is a small continuing expense for the company with registered bonds, because of the transfer fees when bonds are bought and sold; however, this expense is more than offset by the fact that the company has an up-to-date list of its bondholders in case it is necessary to contact them. Convertible bonds, which are of interest to the individual investor, are in small denominations of $100 principal amount and in coupon form.

Since bonds may be in different denominations, their prices are expressed as percentages of principal amount. A price of 100 means 100% of the principal amount, whatever the denomination. This is in contrast to the price of a stock, which is expressed in dollars per share.

A less formal type of indebtedness is a note. It may be secured. Like a bond, it briefly states the amount owed, the interest rate and the maturity. As with a bond, there will be a more lengthy document, known as the loan agreement, which spells out the provisions of the loan. It corresponds to the indenture for a bond, except that the loan agreement is a contract between the lender and the borrowing corporation rather than with the trustee, who therefore may be eliminated.

The Trust Indenture Act of 1939, which is administered by the Securities and Exchange Commission, was passed for the purpose of protecting bondholders from the dangers of inadequate indentures and unqualified trustees. The need for the Act became apparent in the depression of the 1930's when there were so many business failures, and resulting financial reorganizations. The Trust Indenture Act attempts to insure that the trustee will be qualified, be independent, be subject to penalties for failure to act, etc. An indenture is qualified by including therein such provisions as are required by the Trust Indenture Act. It does not attempt to define the standards required to maintain sound credit, because these trust provisions apply independently of the Act and depend on the nature of the company.

The provisions of debt securities have to cover a multitude of ideas. Their extent will depend on the nature of the security. Some of them may be put in the following three categories:

1. *The terms of the issue,* such as the interest rate, maturity, sinking funds, redemption provisions, etc.
2. *The protection provisions,* which assure payment of principal and interest, and maintenance of the quality.
3. *The default provisions,* which define what constitutes a default and the rights of the security holders when a default occurs.

We will be concerned with some of the terms in the first two categories. This is not to minimize the importance of the default provisions. If inadequate thought is given to them when they are drawn, they can cause serious trouble if the company runs into difficulty. As previously stated, they should be thought out as if default were just around the corner.

We will discuss some of the terms which apply to most types of debt issues.

### *Maturity and Sinking Fund.*

First, how long should the maturity of your bonds be—10 years, 20 years, 30 years, 50 years, or even perpetual?

Examples can be found of practically all possible maturities. Generally, the question is not a major problem, because the maturity for a particular type of company tends to follow the pattern which has been set by other similar issues. However, the question is far from academic and a company should have a good reason for choosing whatever maturity is decided upon. Sinking fund is so closely related to maturity that we will treat it along with maturity.

Other things being equal, companies unconsciously seem to favor long maturities, since that will give them the use of the money for as long a period as possible. Also, they thereby postpone the trouble and expense of refinancing the maturity. Some financial experts, in fact, urge such a policy. However, merely lengthening the maturity for such reasons alone may not be the best course to follow. It may mean that the company will have debt outstanding in the more distant future when the company's character has changed and when that debt would be inappropriate. Such a policy may disregard some of the principles discussed in Chapter II on capital structure.

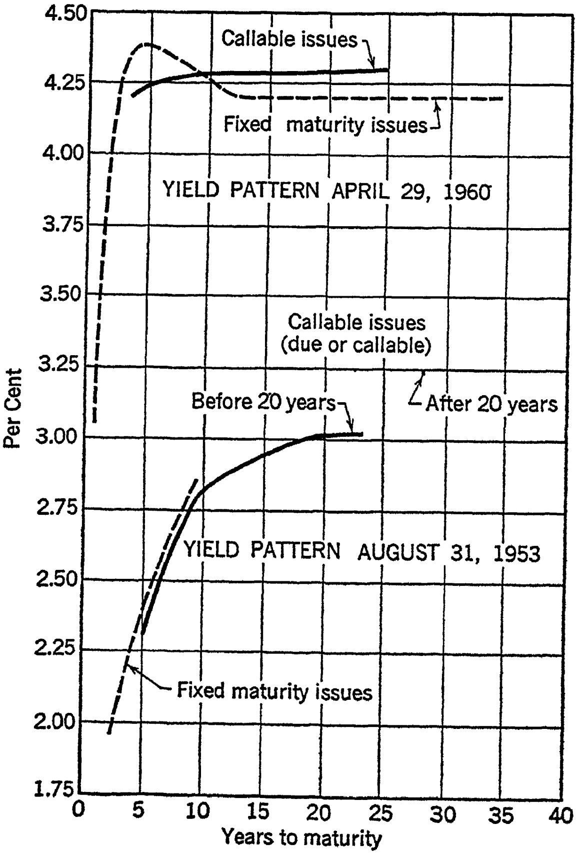
There are two sides to the coin in deciding on the maturity. They are the character of the company and the condition of the bond market.

The nature of some companies is such that they should not attempt to issue bonds with long maturities. One very good reason is that investors would not purchase them. Examples of such situations occur where there is a wasting asset, or where a company is dependent on contracts for sale of a product for a limited period. A company in a risky type of business or one with poor credit may be in a similar position. In other words, the maturity must be within the period that the company has prospects of assured income. A company is only asking for trouble if it attempts to drag out the maturity longer than is economically reasonable. On the other hand, some companies, which replace their fixed assets in the regular course of business, have a relatively stable income and high credit standing, are freer to choose whatever maturity seems appropriate.

The other side of the coin is the nature of the market for debt securities at the time of the proposed security sale, particularly the cost expressed as yield for different maturities. A company will wish to consider the differences in yield within the maturity range which the company's character will permit. The yield pattern will vary with maturity from time to time, depending on the demand and supply for short- and long-term funds. Generally, interest rates are thought to be lower for the shorter maturities, but the slope of the curve varies considerably. At times, the reverse has occurred, and short-term rates have been higher. These remarks, of course, refer to interest rates on bonds of equal credit rating.

A company can get an idea of the effect of maturity on interest rates by first referring to the yield on U. S. Government bonds with different maturities. This information is readily available in chart form in the monthly bulletin of the United States Treasury.[1] An example of the chart contained in the bulletin is shown immediately below for two dates when the yield pattern was quite different. These yields[2] represent the rates on the highest type of credit. One factor which should be kept in mind about governments and the possible effect they may have on the level of rates and the pattern, is their liquidity. There is a ready market for a large amount of governments.

Yields of Taxable Treasury Securities
Based on Closing Bid Quotations



Yields on corporate bonds would naturally be higher. Furthermore, the pattern might be somewhat different. As the quality of corporates falls, the spread would tend to be greater for the longer maturities, because of the greater uncertainty of payment for the weaker issues. In order to get some idea of the pattern for corporate bonds, it is necessary to refer to data on non-convertible corporate bonds with different maturities and the same credit rating as the company in question. Care must be taken for the possible effect on the yield of a sinking fund or serial maturity, the call price, if the issue sells above call, and the size of the interest coupon. As will be pointed out in the next chapter, the yields on outstanding bonds will not give the rate at which a new issue can be sold, but it will give some idea of the effect of different maturities on yield. Of greater importance are the offering yields on recent new issues of corporate bonds of similar quality with different maturities. It may be impossible to obtain an adequate sample of corporate bonds with different maturities and comparable quality. Then you will have to rely on the advice of an investment banker, who should be able to make an educated estimate because of his closeness to the market.

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[1] *The Treasury Bulletin,* Superintendent of Documents, U.S. Government Printing Office, Washington 25, D. C. Subscription per year $4.25 domestic, $5.25 foreign. Single copy varies.

[2] When a Treasury issue is above the call price, the yield is figured to the first call date.

Having decided on the longest maturity consistent with the nature of the company, the next question will be whether repayment should be made prior to maturity on a serial basis, or with a sinking fund. Actually, this matter cannot be disassociated from the maturity question.

The two sides of the coin come into play again in deciding on annual paydown before final maturity. The pattern of the debt reduction—when it starts, the annual payments and total amount—should be tailor-made to each company. It should at least be sufficient to reduce the debt to a reasonable level in line with future potential risks. If a company's credit is weak, the repayment schedule may have as its purpose to improve gradually the company's debt ratio. One of the tests in deciding on the amount of annual payments a company can carry is coverage of debt service. It is the number of times that earnings, after expenses and taxes, but before deducting depreciation and other non-cash items, cover interest charges and all debt repayments. This shows the margin of cash flow to meet fixed payments on debt. It should be figured with lease payments included in fixed charges. Some analysts test coverage of debt service for industrial companies after deducting depreciation.

Some companies have a tendency to fight the inclusion of sinking funds or serial payments in their debt issues, feeling that they are a disadvantage and a form of cost. They are, of course, a drain on cash, and insofar as additional financing is required to repay them, they will necessitate financing costs. However, on the plus side, it should be recognized that they, in most instances, reduce the interest cost, and also that they do improve a company's credit position as time goes on. Furthermore, a satisfactory schedule may reduce the severity of the restrictive provisions. This is only natural. The reduction in debt gradually decreases the burden of payment on the company and, correspondingly, the investor's risk of non-payment. In other words, it is a provision which, if viewed objectively, has real advantages.

Should your debt reduction be through a sinking fund or serial maturity? A serial maturity has the advantage of reducing the average maturity of the debt for the purposes of yield calculations by the investor. If interest rates are lower for shorter maturities, the company will derive a greater advantage in a lower average rate than it might from a sinking fund. The reason for this is as follows: a reduction in debt by a sinking fund is handled by calling bonds by lot through the trustee, or purchase in the open market. No one holder of the bonds knows whether he will have his bonds called. Therefore, in calculating the yield, each bondholder must assume that he will have to wait until final maturity, with only the possibility that he will be paid before then. On the other hand, the holder of serial bonds has a definite payment schedule. This is not to say that no investor will look at the average maturity of a sinking fund bond, but he may give it little weight as far as the effect on yield is concerned, unless he owns the whole issue, or is otherwise assured of pro-rata call for the sinking fund. However, the company certainly should figure the yield to the average maturity.[3]

A sinking fund may have an advantage as far as the company is concerned over a serial issue. The company may be more able to purchase the bonds at a discount in order to satisfy the sinking fund, and thus save money. Its ability to purchase the bonds at a discount will depend upon the future pattern of bond prices and how the bonds are held. The wider the distribution of bondholders, the better the company's position to purchase bonds for sinking fund. If a company sells bonds privately, it should consider carefully whether it will be totally blocked from ever buying bonds at a discount for sinking fund purposes. Then, in effect, a sinking fund bond is the same as a serial bond.

In a serial issue, the interest rate may be the same for all maturities, with different offering prices for the different maturities to meet the market demand, or the offering price may be the same with the interest rate varying. Serial maturities have been used largely in equipment trust certificates for railroads, but seldom for industrials. This does not mean that their pros and cons should not be weighed whenever offering debt. Some problem may be encountered in listing a serial bond on the New York Stock Exchange, because of the requirement of separate application and quotation for each maturity. However, under today's conditions, listing of a debt issue is not of sufficient importance for this to be a major obstacle.

Examples of many varieties of sinking funds can be found. The amount may be equal annually or varying on different bases. The amount may be dependent on earnings or production; in the case of a wasting asset, it might be a certain number of cents per barrel or ton. There may be optional amounts. However, the most common is a fixed annual principal amount. While sinking funds do have some advantages, they also may get a company into financial difficulty when too heavy. This, of course, is generally a sign of too much debt in the first place.

Most industrial company bonds have sinking funds. The risk factor is such that the investor requires it. In the electric utility field, mortgage bonds generally do not have fixed sinking funds requiring debt reduction. For such companies, the sinking funds are small because of the nature of their business and in most instances can be satisfied by putting up new property on a limited basis. This keeps up the security behind the debt. For example, if the issuance of new mortgage bonds is limited to 60% of net property additions, an equivalent amount of property can be used to satisfy the sinking fund. This has an advantage for such a company in that, as expansion continues, existing bonds do not have to be paid off. This type of sinking fund is applicable only to companies which have special characteristics and, in addition, a high credit standing.

Purchased bonds can be tendered usually by the company to the trustee at 100 to satisfy sinking fund requirements in lieu of cash. They may be acquired by purchase in the open market or through tenders, or in some instances through negotiation, if an issue was sold at private sale. If not so available, then the bonds may be called by lot at the sinking fund call price.

By studying debt issues of companies like your own, you can obtain an idea of the general pattern of serial maturities, sinking funds and final maturities. This will be a good starting point. You should then evaluate the situation for your company on the basis of the two sides of the coin discussed above.

Just to show how there may be radical de-

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[3] The average life of an issue is obtained by multiplying the time to each maturity by the amount of each maturity, and dividing the total by the total amount of the issue:

| *Maturity in Years* | *Amount* | *Maturity, Multiplied by Amount* |
|---|---|---|
| 1 | $20,000 | $20,000 |
| 2 | 50,000 | 100,000 |
| 3 | 30,000 | 90,000 |
| | 100,000 | 210,000 |

$$\text{Average Maturity} = \frac{210{,}000}{100{,}000} = 2.1 \text{ years.}$$

partures from the norm as far as maturities are concerned, we will refer to two examples.

When interest rates were low in the early 1950's, a few well-known industrial companies sold bonds privately with a 100-year maturity to a few large institutional investors. There was an interesting additional provision. There was an optional provision permitting a change in the maturity after a few years. For example, one such loan made in 1951 carried an interest rate of 3¾% for 100 years. Both the lending institutions and the company had the right to change the maturity in 1959 into a 25-year loan with a 100% sinking fund of equal annual payments, starting five years hence. If such a request were made, the interest was to be reduced to 3½%. In 1959, the lending institutions took advantage of this option. You may wonder why. The answer is found in the fact that interest rates had increased substantially to above 5% in that year. It was the appraisal of the lending institutions that rates would continue high, and as the loan was repaid through the sinking fund at 100, they would be able to reinvest the money at a higher rate. From the point of view of financial policy, the companies issuing such debt would have had to assume the short maturity when it was issued, since the option was with the investors. That was the way it actually worked out. It may be noted that, had this been a public offering rather than a private sale, the company might have been able to purchase bonds in the open market at substantial discounts for sinking fund purposes.

Another piece of financing which was an example of a maturity out of the pattern for similar types of issues was a large issue of debentures sold by an electric company in 1949. The company subsequently sold other similar issues. At the time, the pattern for maturities of long-term debt by similar types of companies was 25 or 30 years. The interest rate on the debenture issue we refer to was 3% and the final maturity 50 years. A 2% sinking fund was provided, to retire an equal amount each year so that the entire issue would be taken care of by maturity. This bond was offered publicly. Thereafter, the company was able to realize substantial savings through purchase of bonds for sinking fund in the market, when interest rates increased and the price of the bonds accordingly fell in price. For example, in February, 1960, the bonds were quoted at 68½%. This was entirely due to a change in interest rates and not to the quality of the issue.

These two examples are not presented for purposes of discussing their pros and cons; that would take much analysis. They are merely included to show how it may be possible to step out of the general pattern.

### *Redemption Provisions*

A debt issue may have two sets of prices at which it can be paid off before maturity. One provision applies if the company is forced to reduce debt in compliance with the terms of the indenture, such as for sinking fund purposes. It is referred to as the sinking fund call or special redemption provision. The other call is referred to as the regular or optional redemption provision and may be used at the company's option.

First, a few words about the sinking fund or special redemption provision. Reduction of debt for sinking fund is for the purpose of assuring repayment of principal, as with a serial maturity. If a bond is sold at 100 and the company is forced to reduce the debt by sinking fund prior to final maturity, it should not have to pay more than 100 for such purposes.

To see the effect of having the sinking fund call price above 100 in such a situation, consider the following example. One investor offered to buy an entire debenture issue in a private sale at a price of 100 and an interest rate of 5%. The maturity was to be 10 years with an equal annual sinking fund which would pay off the entire issue in 10 years. Another investor offered a price of 100 and an interest rate of 4¾%. At first, the borrowing company was happy with the second offer because it was able to save ¼% interest. However, there was a catch. The investor who offered the 5% rate established a sinking fund call price of 100, as would be expected. Here is where the catch came in. The second investor had in mind imposing a sinking fund call price of 101½. That would have meant that each year the company would have to pay 4¾% interest and 1½% penalty for retiring part of the bonds for sinking fund. This was approximately equivalent to selling the bonds at 98½ with a 4¾% interest rate and a sinking fund call at 100. That would mean a yield of 5.06% based on the average life of the issue. The company would have been worse off if it had accepted the 4¾% rate with the higher special call price.

If bonds are sold at a premium above 100, then naturally the sinking fund call price should start at that premium,[4] because an investor would not wish to obtain less than the money he put up. When the sinking fund call price is above 100 because the bond is being sold at a premium, the price is gradually reduced each year. This is to compensate for the fact that part of the interest rate is to take care of the write-off of the premium prior to maturity. The premium is decreased on the basis of a constant yield, as obtained from bond value tables. It graduates towards 100 at maturity. If you are not familiar with figuring the yield of a bond, it is explained in the next chapter. To illustrate, a simple example is as follows: A 10-year bond is sold at 101.97 with a 5% interest coupon. The yield to maturity at a price of 101.97 is 4.75%. The bond will be placed on the investor's books at 101.97, and each year thereafter the book value will be reduced to that price which corresponds to the yield at the time of purchase. Redemption at any other price will result in either gain or loss; hence the redemption prices are fixed at values corresponding to a 4.75% yield for a 5% bond for the terms remaining to maturity. These would be as follows: 101.81, 101.65, 101.47, 101.29, 101.10, 100.90, 100.69, 100.47, 100.24, 100. The figures were taken directly from Bond Value Tables.

But note that if a bond is sold at a discount, the sinking fund call will be at 100. In such a situation, the company is paying an additional charge to the extent that bonds are retired for sinking fund at 100. A company should take this into account if it sells bonds below 100 with a fixed sinking fund. This will show up in the yield calculated on the basis of the average life of the issue.

There may be other provisions in an indenture requiring payment of the debt before maturity, such as on the proceeds of the sale of property. Such a requirement, if obligatory, should also provide for redemption at the sinking fund call price.

Now we turn to the regular call provision. Its purpose is to permit the company to eliminate the issue in whole or in part at its option, if future conditions make it advisable to do so. However, the company must pay a premium if it exercises this option, since this is a privilege and not an obligation.

It has been suggested that investors are perhaps inconsistent in requiring a sinking fund and thus making a company reduce the debt, yet at the same time requiring a premium if the company retires more than the sinking fund amount. Actually there is no inconsistency. The purpose of the sinking fund is to assure sound credit and payment of principal. On the other hand, the purpose of the regular call premium is to prevent the company from taking that part of the investment away which is considered appropriate from a credit angle without compensation for the trouble that the investor went to in advancing the money.

There are two questions involved in the regular call feature: its size and the pattern of the decrease. There, of course, need not be a decrease, but if not, then, in effect, the penalty becomes greater as the maturity decreases with the passage of time, due to the nature of bond yields.

The pattern for a regular call price for a non-serial bond is different from one with serial maturities. The serial bond generally will have lower call prices for the shorter maturities. This again is due to the nature of bond yields. In a serial issue, there is generally the requirement that retirements be made in order of longest maturity. Henceforth we will be discussing the redemption provisions for a non-serial bond.

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[4] Since the special and also the regular redemption prices may be dependent on the price of a new offering, it may be necessary to await the offering price in order to calculate them. This is one of the rush jobs that takes place at the time a bid is opened at competitive bidding. They are generally figured by the company with its auditors, and checked by phone with the Financial Publishing Company, financial actuaries located in Boston.

As to the amount of the premium for a non-serial bond, one approach is to start with a penalty of one year's interest. In other words, if the company decides to call the bonds, it must pay one year's extra interest. This must be added to the premium, if any, at which the bonds are sold above 100. For example, if a bond is sold at 102 with a 5% interest coupon, the call price might well be 107 for the first year. A current pattern, widely applicable, is to reduce the call price an equal amount each year so that it reaches 100 one year prior to maturity. It would seem to make more sense to have it decrease on the same basis as for the sinking fund redemption fund. Some institutional investors purchasing at private sale may demand this, but the present custom, certainly on public issues, is not that way. In analyzing call prices, whatever pattern is used, a company should figure the yield of each call price for the term remaining to maturity. A low call price close to maturity is important, because it gives the company a better opportunity to evaluate the advisability of anticipating a refunding operation prior to maturity if circumstances are favorable. That is why it is reduced to 100 one year prior to maturity.

In the 1940's, interest rates were very low. As a result, companies called their existing debt, which had previously been issued with high interest rates, and refunded it with new low interest rate issues. This was very disturbing to the large institutional investors having a substantial part of their funds invested in such issues. It meant a sizeable reduction in their income. Having been badly stung by this process once, they were in no mood to have it repeated again when they purchased new issues during the period of rising interest rates in the 1950's. In order to protect themselves as funds for investment became scarce and they were better able to impose more favorable terms, they insisted that a non-refundable provision be tacked on to the regular call feature. It prevented refunding the bonds for five years, for ten years or even for the life of the issue, with another debt issue at a lower yield than that at which the bonds were originally sold. Thus, they blocked the company's option to take their investment away from them if interest rates should decrease in the near future.

This was viewed as a rather highhanded approach by some borrowing corporations. They felt that it was being unfair. This feeling does not seem to be justified. If the money situation is such that investors can obtain a non-refundable provision as part of their price, they should be free to do so; it is quite understandable why they would try. On the other hand, a company would do well to avoid such a provision if possible. In fact, if necessary, it would be preferable for a company to pay a somewhat higher interest rate. At times in 1959, it was estimated that a regular call provision would require a higher interest rate from ⅛% to ¼%, as compared with the rate on the same issue having a five- or ten-year non-refundable provision. What policy a company follows will depend on the circumstances at the time of the offering. It may be noted that some regulatory authorities with jurisdiction over some companies are opposed to non-refundable provisions as a matter of policy. In some instances, if a company does not include such a feature, a somewhat higher original call provision may be used to sweeten up an issue in a period of tight money. For example, instead of adding one year's interest to the offering price, there might be included one or two additional points.

A non-refundable provision should be distinguished from a non-call. The former is only for the purpose of preventing redemption to save interest through issuing another bond at a lower interest rate. It does permit redemption at regular call prices if the issue must be eliminated in connection with a merger, consolidation, etc. This preserves flexibility for a company. A complete non-call will prevent redemption for any purpose and should be avoided.

One more point might be added in connection with the call feature. The company must issue a notice of call, usually not more than 45 nor less than 30 days prior to the day on which the bonds are to be redeemed. If a refunding is being done, the company may have to raise the necessary money before it issues the call, as it might be in default if it fails to get the money after the call has been issued. This results in payment of interest on both issues during the notice period. This may be eliminated by having the call provision include a conditional call feature, the call to be effective only if the company is able to raise the money. Thus, the company does not stand the risk of default, if it waits to raise the money, until after issuing the notice and then fails to do so.

### *Protective Provisions*

Now we turn to protective provisions. In broad terms, the means of protection, as viewed by the investor, may take one of the following forms or maybe a combination thereof:

1. *A lien in one way or another on a readily salable asset* which can be used for obtaining payment, if the company fails to pay. A lien on automobiles would be in this category. They are readily marketable at a price. A margin of protection must be maintained to take care of the danger of a price decline if sale is necessary.

2. *A lien in one way or another on an asset which may not be readily salable, but which can be taken away from the borrowing company* and which is so important to its operations that the company will have to continue payment in order to operate. A railroad equipment trust certificate with a lien on railroad cars is in this category. During adverse conditions, there might not be a market for the railroad cars, but the railroad cannot operate without them and even might pay this obligation before payment of debt, having a mortgage on the roadbed. The company must have a sufficient equity in the property to assure that there will be an incentive to pay the charges on the senior obligation under adverse conditions.

3. *A lien on an asset which is an integral part of the assets* of a company and could not be removed, and which is primarily of value as used by the company itself. A lien on such property is principally of value to the investor through the assurance that it gives of a senior position over other debt issues. This type of asset is typified by the roadbed of a railroad or the plant of a specialized manufacturing company.

4. *A lien in one way or another on a flow of income* to the company from some assured source, with a sufficient margin to cover the risk of decline in the flow.

5. *A general obligation of the company* with no specific lien, but with provisions protecting the position of the security as to assets, liabilities and earnings, with a sufficient margin to allow for the nature of the risk involved.

From the above, it can be seen that the two extremes in protective provisions are: reliance solely on lien vs. reliance on a general obligation with no lien. Where reliance is solely on a lien, it provides a means of repayment if there is a default, or provides inducement in itself for the company to continue payment. At the other extreme, with a general obligation, the investor will have to require provisions which will protect his position in relation to other securities and assets, and also keep the company from becoming too weak financially. Whenever there is a combination of the two, the lien itself should be analyzed to determine its main purpose: to assure a means of payment by itself, an incentive for the company to pay, or a means of establishing seniority of position with regard to other security holders. The nature of the company and its assets may determine the type of obligation that can be used. In some instances a lien is just not workable.

Where a lien can be used, it may be said that there are two schools of thought regarding how the investor may achieve protection. One emphasizes the importance of a mortgage or lien position, although it alone may not assure repayment; the other school believes in an instrument for the maintenance of the financial health of the enterprise. In the opinion of one large institutional investor, the added provisions in mortgage bonds since 1940 have been more in the direction of the second school, that is, to protect the credit of the company in addition to having a lien. And this seems more in line with common sense. The plant of many corporations, unless it is of a very general nature, only has real value as it is used to create earnings by the owning company. If the earnings cannot be maintained, the bondholder does not obtain much advantage through foreclosure and possession or sale. Furthermore, the long procedure necessary to realize on the property is most painful. Therefore, the indenture in a mortgage bond today will look toward keeping the debt within reasonable limits so that even poor earnings will make service possible, and with provisions which will tend to keep the credit strong. Such provisions as coverage requirements and maintenance of working capital are in line with this idea. In fact, even some of the provisions which are strictly of a mortgage nature may be evaluated as to how they may force the company to maintain a sound credit. This, of course, does not mean that unsecured bondholders will be disinterested in maintenance of the property in a good condition. That is an essential part of protection of assets even if not mortgaged.

From the company's point of view, the type of protection provided should be analyzed in terms of its possible effect on the interest rate, on flexibility of financing and on other factors previously mentioned. The company should consider what exceptions to property mortgage may be made to facilitate practical operations of the company.

The relationship of a security to the assets or income to which the holder looks for protection may be direct or through a lease or dummy corporation. No matter what the veil, the investor is interested in the substance. Nevertheless, the more indirect his position, the higher may be the rate of interest, because each additional contract may add some risk. There is always the possibility that some flaw may develop in a contract and be challenged if there is financial failure.

The senior security holder will wish to assure that a margin of protection is maintained in either a specific asset or income or in all the assets and earnings. Therefore, he will wish to be certain that there is no dissipation in whatever he relies upon for the protection, and many of the provisions of a security will be for the purpose of preventing such dissipation. At this point, you may wish to visualize how there may be a dissipation of assets and earnings. This can arise only through transactions ultimately affecting the balance sheet or income statement. The terms of a bond may not be expressed this way, but the brief outlines (below and on page 102) based on the effect on these statements, may help you understand why so many contingencies have to be guarded against.

### INCOME STATEMENT

(See balance sheet outline on next page)

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*Above the line* (expense items which are before income available for payments to investors):

- Excessive salaries or other expenses which sap earnings. This also may occur when the management owns a sales or purchasing company and thus exacts tribute from the company, which it is supposed to be running for the stockholders—highly unethical.
- Incurrence of fixed payments, such as lease rentals or other payments akin to debt.
- Overstatement of earnings due to low depreciation or maintenance.

*Below the line:*

- Excessive dividend payments.

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The investor will have to weigh the need to guard against all of these possibilities. The company should recognize such a need, but it should be careful that the terms will permit it freedom of action within the limits required to protect the investor.

BALANCE SHEET

*Assets*

Transfer outside the company in one way or another such as through sale, lease, etc., so that the position of a security may be adversely affected.

Transfer to a subsidiary without adequate compensation, or so that the position of a security is hurt.

Acquisition of an inferior asset for which a good asset is given up, or an excessive obligation is incurred.

Purchase of assets at an excessive price. This may occur when management abuses its trust by purchase of an asset and then resells it to the corporation at a profit. This is, of course, highly unethical.

Pledge to another security.

Use for payment or repurchase of another junior security of the company.

Decrease in working capital below a reasonable level, necessary to carry on operations.

Inadequate insurance.

Failure to maintain in condition.

Failure to pay taxes and assessments.

Failure to defend title to property.

Excessive law suits not properly defended.

Loss of special franchises or patterns.

Loss of corporate entity.

*Liabilities*

Incurrence of other obligations senior to or with an equal lien, through sale of securities, or which arise in a merger, consolidation or acquisition.

Reduction of equity protection by paying dividends out of past accumulated earned surplus, or repurchase of junior securities out of company funds.

Sale of equity to insiders at unreasonably low price.

Since all possible contingencies cannot be seen, a provision is included permitting modification of the terms. Usually, for a bond, the consent of the holders of 66⅔% of the bonds must be obtained for the modification of any important provision. This does not apply to the interest rate and maturity which, in respect of any bond, cannot be changed without consent of the holder of such a bond.

### *Varieties of Debt*

The greatest variety in type of securities occurs among debt issues. This is because there are many means used to protect the investor as regards assets and earnings, and to establish the position of the debt in relation to existing and potential securities in the capital structure. For example, a mortgage gives the holder a lien on certain property; debentures and notes have no lien, but are a general obligation; equipment trust certificates have a lien on a special type of asset; lease financing gives title to the investor, etc. We will cover briefly the principal types of debt issues in broad terms, proceeding from secured to unsecured.

### *Mortgage Financing for Real Estate*

The most basic type of secured debt financing is that of a real estate mortgage. In effect, it is similar to a mortgage loan on a residence. For large corporations, it is limited to situations in which money can be raised from a few large institutional investors, since it is not suitable for a public offering. Only two instruments are required—that describing the borrowings and terms, and the mortgage itself. There is no indenture to be administered by a trustee. Types of companies which institutional investors may be willing to finance with this medium are stores, hotels, theatres, garages, warehouses, office buildings, factories, etc. The property on which the mortgage is made has a market value, affording protection to the lending institution through the possibility of sale if there is a default. In order to afford a margin of protection, the investor will wish to restrict the amount of the financing to a certain percentage of the value of the property. Most fiduciaries are permitted by law to lend only up to 66⅔% (75% for some institutions) of the appraised value. The mortgage will apply to a specific piece of real estate. As far as that property is concerned, it will be closed-end, that is, limited in amount to the original issue. Since it is the property to which the lenders look for security, there will be no general restrictions on the company's over-all financial policies. There will be ample provisions, of course, covering maintenance of the specific property in good condition, and so forth, and the repayment schedule will assure a continuing margin of value above the amount of the mortgage. The advantages and disadvantages may be summarized as follows:

MORTGAGE FINANCING FOR REAL ESTATE

| *Advantages* | *Disadvantages* |
|---|---|
| 1. The expense of a trustee is eliminated. | 1. The amount of money that can be raised will be limited to a percentage of the appraised value of the property. |
| 2. It has the inherent advantages of a private sale, such as speed of arrangement, reduction of financing expense, possible change in terms through negotiations with a few investors. | 2. As far as the specific property is concerned, it may not be available for use in securing other debt obligations. |
| 3. There may be no terms restricting the company's general financial policies. | 3. It is limited to situations in which institutional investors are interested in making such loans and the transaction can be handled as a private sale and not a public offering (as will be explained in the next chapter on selling senior securities). |
| 4. It does not have an after-acquired clause attaching to other separate projects of a company. | 4. It has the inherent disadvantages of a private sale, for which see the next chapter; for example, the reduction in debt must be made at 100, the possibility of purchase in open market at a discount being nonexistent. The investor is in a strong bargaining position and may require a higher interest rate than might be obtained with some other form of debt financing. |

### *Mortgage Bonds*

Mortgage bonds are different in form from a real estate type of mortgage in that the mortgage on the property is held by a trustee for the benefit of bondholders. The mortgage generally will cover the entire properties of a company rather than just a specific building, but it need not do so. There is an indenture which describes the terms of the bonds and which is administered by the trustee. This form of secured financing permits more investors to be included and permits the possibility of a public offering. Concerning the theory of protection for investors, we now run into the two schools of thought as to how the protection may be achieved—through limitation of indebtedness to a certain percentage of the property, or primarily through additional terms regarding earnings covenants, etc. As has been previously indicated, today the two schools are intermingled.

The form of the mortgage will depend on the state or states in which the property is located, since the state laws will govern. If a company has widespread properties which are changing rapidly, a mortgage may be cumbersome to handle, because the lien must be recorded in all the counties in which the properties are located. This is a routine matter, but it can run into real money when the property is located in many counties.

Some companies have property which just does not lend itself to being mortgaged; others own properties suitable for this form of financing. Typical of the latter are the electric utilities with very large tangible assets which are expanded in a regular manner; most of them use mortgage bonds as their principal form of debt financing. In the case of a utility, the mortgage primarily provides a means for assuring seniority of claim. Such property could not be sold to provide cash for payment if there was a default. It is interesting to note in the utility field, however, that most of the subsidiaries of American Telephone and Telegraph Company have not used mortgage bonds. Conversely, the railroads relied heavily on mortgage bonds when they were built. Many of these mortgages were closed-end divisional liens, and they made almost an insoluble mess of debt issues. In reorganization and subsequent refinancing, the divisional liens were eliminated wherever possible and turned into a general mortgage. In the industrial field, mortgage bonds are used by some companies which have large fixed assets.

Why should a company use a mortgage bond, if they are so cumbersome? There may be three reasons. In the first place, in certain situations, investors may feel that they need the added protection and will not do the financing any other way. Secondly, a mortgage bond may add to the security for the investors, and as a result this may mean a lower rate of interest. In some special situations a mortgage bond may have some influence on the bond rating, as compared with a debenture with weak terms. A third reason to justify the use of a mortgage is that it may give a company more freedom to put out another form of debt, such as a debenture. Since the investor has an underlying position as a result of the mortgage, the provisions limiting junior debt may be less strict. If there were no mortgage bonds, and only debentures and a junior debt issue were desired, it might be necessary to issue a subordinated debenture with quite an inferior credit position.

It you look at a textbook on finance, you may find many pages devoted to a long list of different types of mortgage bonds, each one with a high-sounding name and a detailed description of what it represents. It may look like a great maze, but if you study them, it should be quickly apparent that they are just a variation of a general mortgage bond. Some of the types are as follows: Purchase Money Mortgage—to provide funds for an acquisition and secured by a mortgage on that property; General and Refunding—its proceeds to be used to pay off a maturing issue or refund an existing issue and also provide funds for other purposes; Divisional Bonds—secured by a lien on a part of a company's property, most prevalent in railroads; Terminal Bonds—specifically a mortgage on the terminal of a railroad owned by a separate company which receives its income from the roads using the terminal; Mortgage and Collateral Trust Bonds—secured by property plus securities as additional collateral, and called by the latter term when only securities are involved, such as in the case of a holding company.

At this point, we might digress a moment to say a word about collateral trust bonds although they do not come strictly under this heading. As just mentioned, the term applies to a bond secured by pledge of assets which are not of a nature that can be covered by a mortgage, as, for example, stocks or bonds of another company. Except in special situations, they are little used today. A debenture bond can generally serve as well, with adequate protective provisions. The only added feature which the collateral trust bond affords is the hypothecation of the collateral with a trustee, in order to add to the safety factor and provide for its sale if there is a default. Under some circumstances, this form of security may be a necessity, or it may produce a lower rate of interest.

Examples of all the types of secured bonds mentioned above and many others are in existence today, but most were issued years ago. At present, new issues of mortgage bonds tend to have a first or general open mortgage on all the property of a company, although there are exceptions. Mergers and consolidations may complicate the picture. There may be a second mortgage. However, the more complicated the debt structure, the less flexibility is available in future financing. Unless there is a very special situation justifying a policy of complexity or unless it is a matter of dire necessity, it should be avoided.

A mortgage bond as designed today will generally be open-end. This permits the issuance of additional bonds up to a certain percentage of new property additions, provided certain tests as to the company's financial strength are met. These will be discussed later on. A closed-end mortgage, which will permit no new bonds with a similar lien to be issued, may place a company in a financial bind. It means that any new debt associated with the same asset will have to be in a junior position. A limited open-end mortgage, wherein new bonds can be issued up to a certain stipulated amount, may turn out to be disadvantageous if the company grows at a greater rate than expected. If a company has a good credit standing, it should have no trouble keeping a mortgage open-end. Of course, a company with poor credit or a new venture may have to accept a closed mortgage.

A mortgage will generally include an after-acquired property clause, so that subsequent additions come under the mortgage. This is not objectionable, provided new bonds can be issued up to a certain percentage of new property so that as additions are made, there will be property available to use as a basis for new bonds. In some instances, when a new mortgage bond is first issued, further bonds are limited to a portion of the cost only of subsequent property additions. This means that if the original issue is small in relation to original amount of property, the ability to issue bonds in the future will be held down by this initial freeze. Whether a company can avoid such a freeze will again depend on its credit standing.

An outline of certain provisions that may appear in a mortgage bond indenture are as follows:

I. To Create, Maintain, Protect and Account for the Trust Estate.
    A. Created by deed of trust which conveys title to all property to the Trustee for the protection of bondholders.
    B. Lien will extend to all "after-acquired" property, which must be subjected specifically, perhaps by supplemental indenture or additional recordings or both.
    C. Property may be released only upon substitution of like property or the deposit with Trustee of cash equal to fair value, upon application, unless property is no longer used or useful and certificate can state: no detriment to bondholders to abandon.
    D. Property no longer used or useful must promptly be classified as retired.
    E. Property must be maintained in first-class working order and condition; expense related to standards of expenditure or performance, policed by right of bondholder to inspect and enforce correction of any deficiencies found.
    F. Property must be adequately insured with proceeds payable to Trustee, subject to withdrawal to reimburse company for restoration or rebuilding.

II. To Preserve the Lien Position of the Bondholder.
    A. Property descriptions must be adequate to establish the lien, and no equal or prior liens may exist or be created to secure any debt except that additional bonds may be issued under the Indenture.
    B. No defects may exist in title; all attacks

upon realty title or franchises must be defended.

- C. Additional property may be acquired subject either to no liens at all, or to only very limited prior liens which must be circumscribed and often quickly extinguished.
  - 1. Leases existing at date of acquisition may be treated as a disallowed encumbrance of title.
  - 2. See also Sales, Consolidations and Mergers.
- D. Taxes must be paid when due unless contested in good faith, and workmen's and materialmen's liens equally must not be permitted to arise.
- E. Except within limits, no subsidiary may issue debt or equity securities to anyone other than the company.

III. To Maintain the Financial Integrity of the Enterprise.

- A. Company must maintain corporate existence and must comply with requirements of regulatory authorities, if any.
- B. Additional bonds may be issued only upon the basis provided in the Indenture, which will specify, at least:
  - 1. Property base shall be net additions to the Trust Estate; i.e., gross additions less retirements to the date of application.
  - 2. Minimum acceptable earnings for a period recently past as related to the requirements of the total debt including that proposed to be issued.
- C. Company shall prevent defaults under prior liens and in respect of all other indebtedness.
- D. Accounts must be maintained in accordance with sound accounting practice.
- E. Equity cannot be reduced voluntarily; all distributions thereon must be made out of earnings accumulated after a date proximate to the date of the bonds, computed after adequate reservation for depreciation or after deducting depreciation and maintenance expense in amounts not less than a fixed standard.
- F. Investments in or advances to other companies may be prohibited or, if allowed, must be restricted:
  - 1. Subsidiaries; limited amount, securities must be pledged with Trustee (refer also to II, E); no third party interests.
  - 2. Controlled companies; more limited amount except to the extent that earnings otherwise available for dividends may be invested, pledge may be required.
  - 3. Earnings computations for dividends of parent may take amount of dividends received only to the extent earned, and must take account of losses incurred.

IV. To Provide for Sales, Consolidations and Mergers.

- A. Lien must be protected as first lien on property subject to mortgage immediately prior to transaction. Liens securing debts of other company may not be extended.
- B. Surviving company must, by supplemental indenture, assume all obligations and restrictions of the Indenture.

It may be well to review the principal provisions which may be included to protect the credit standing of a mortgage bond:

1. *The aggregate amount which may be issued under the indenture.* This ranges from the closed-end issue, to the completely open-end, with some specified aggregate in the intermediate position. If the other provisions requiring adequate earnings, etc., are sufficiently tight to protect the credit position for the investor, a company should not need to submit to severe limitation as to aggregate amount.

2. *Amount of new bonds in relation to new property additions.* As an example, new bonds may be allowed to be issued up to 66⅔% of net property additions, depending on the nature of the company. Net property must take into account retirement, replacements and depreciation. It may be noted that provision may be made for the issuance of bonds against the deposit of cash with the Trustee, and then drawn down as sufficient property is constructed to comply with the percentage of net property additions. This makes it possible for a company to sell bonds in contemplation of property additions.

3. *Amount of equal and prior lien debt, including proposed financing, limited to a per-*

*centage of some balance sheet item or items.* Examples can be found of many different ways to express this relationship. For example, in some instances total assets have been used as the denominator. Another and perhaps the most logical approach is to express the relationship to the amount of equity, both common and preferred. It is the equity which provides protection for the debt.

It might be expressed by saying that equity had to be 200% of equal or prior liens, which would mean that, if there were no junior debt, the debt ratio to total capitalization would be limited to 33⅓%. For legal reasons, this relationship may be found expressed in many ways. In order to determine its significance from the point of view of financial policy, it should be analyzed in terms of capital structure ratios.

In order to prevent the debt in question from being pushed out on the limb, there almost certainly will be a provision limiting the aggregate amount of prior lien debt which may be incurred or guaranteed. Merger, consolidation or sale of properties could have an effect on the prior position of a security, and provisions may place some limitation on such actions.

4. *Interest on equal and prior lien debt, including the proposed financing, covered a certain number of times by earnings in a recent period.* This provision may be expressed in many different ways. It undoubtedly will provide for the inclusion of lease payments along with the interest charges. It is a most important provision from the company's point of view. Its possible limitation of further debt issues should be analyzed in terms of poor earnings, to insure maintaining leeway for borrowing reserve.

If a company's debt requires heavy sinking funds because of wasting assets or for some other reason, there may be an additional provision as regards coverage of debt service by

MORTGAGE BONDS

| *Advantages* | *Disadvantages* |
|---|---|
| 1. As contrasted with a real estate type of mortgage financing, which must be sold privately, mortgage bonds make possible a public offering of securities. This may result in some advantages. | 1. Handling of assets on which mortgage applies may be cumbersome. Recording the mortgage in each county where property is located requires added expense. |
| 2. May result in a lower rate of interest. | 2. The multiplicity of security instruments involves some expense. |
| 3. May be the only basis on which investors will buy a particular company's debt securities. | 3. May add to the difficulty of merger, consolidation or sale, etc. There may be a problem of working out a surviving mortgage when two companies, each with mortgage debt, are merged. |
| 4. There may be less restrictive provisions in issuance of a junior form of debt such as a debenture. This may make possible a second debt issue such as a debenture without designating it as a subordinated debenture, which would be necessary if the senior form of debt was a debenture. | |
| 5. It may make possible the sale of the issue to certain institutional investors which are limited by law to investing in issues secured by a mortgage under certain circumstances. | |

cash generated through earnings available for that purpose. This should be tested in a similar way as coverage of interest charges, in order to provide borrowing reserve.

5. There may be a covenant that *net working capital or current ratio must be maintained at a certain level.* For example, current assets might be required to be maintained at 2 or 2½ times current liabilities; or net working capital, that is, current assets less current liabilities, required to be maintained at a certain dollar level.

You may feel that such a provision might hinder rather than help a company if it got in a financial bind, because it could not use its current assets for an emergency. The purpose is threefold: to prevent a company from letting its working capital get so low that its operations will be hurt; to prevent a company from relying on current borrowings, on a permanent basis, which are, in effect, long-term obligations; and to prevent a company from being just a shell if it runs into trouble so that there is nothing left to rehabilitate.

6. *Restriction on dividend payments.* This provision will take the form of a freeze of either all or some of past accumulated earned surplus. It will include a restriction on the use of funds for the repurchase of a company's stock so that the equity protection will not be decreased.

The importance and extent of each of these provisions will depend on the nature of the company. They are the principal ones which may restrict a company's flexibility and should be carefully tested in order to appreciate their effect under adverse conditions, having in mind the importance of keeping debt within satisfactory limits so that "borrowing reserve" will still be available.

The advantages and disadvantages of mortgage bonds in general are shown on page 107.

Examples of a few of the provisions contained in the indenture of three actual mortgage bonds follow on page 109. They are so summarized for easy reading, but they may not represent the true legal import as they apply to the actual issue. They are merely presented to give an idea of their scope.

### *Equipment Trust Certificates*

Equipment obligations are, in effect, a chattel mortgage on specific units of equipment. If a company is dependent on the equipment for its operation, such as a railroad is on freight cars and motive power, or an airline is on planes, the obligation places the lender in a senior position. Assuming the company could not operate without certain equipment, it could not, as a practical matter, permit a default on obligations secured by such equipment, since loss of the equipment to the company's operations would further aggravate the situation. Moreover, in connection with equipment trust certificates publicly sold, the company usually makes an initial payment of approximately 20% towards the cost of the equipment. Naturally, therefore, the user has an economic incentive to continue payments to protect this equity. Equipment trust obligations are repayable on a serial basis generally at a faster rate than the equipment is depreciated; so there will be a satisfactory equity position throughout the life of the loan.

It is essential that the lien on the equipment be free from all other liens. If a company has no other mortgage debt outstanding, there is no problem. Title to the equipment is, as a rule, transferred to a trustee or agent to secure equipment certificates. The certificates are then sold in the market to provide the user with funds.

However, if a company has a mortgage bond outstanding with an after-acquired property clause attaching to new purchases of property, then one of two methods must be used in order to keep the title to the equipment separate:

1. The property is sold to the user by the manufacturer on a conditional sales basis, with or without an initial down payment. Title is retained by the manufacturer, who passes it on to an agent. The

## MORTGAGE BONDS

| | *Steel Company* | *Steel Company* | *Electric Company* |
|---|---|---|---|
| Dated | February 1959 | June 1959 | October 1957 |
| Interest Rate and Maturity | 4½% due 1989 | 4⅝% due 1989 | 5% due 1987 |
| Principal Amount of Issue | $50,000,000 | $80,000,000 | $60,000,000 |
| Composite Bond Rating | *Single A* | *Double A* | *Double A* |
| Offering Price | 100 | 99 | 100.777 |
| Lien | A first lien on substantially all property along with other equal series | A first lien on substantially all property along with other equal series | A direct lien on substantially all property along with other equal series |
| Redeemable | Not redeemable for any purpose other than sinking fund until after 10 years, and then on 30 days' notice at 103½ for the 11th year, and decreasing thereafter<br>For sinking fund starting in three years at 100 | On 30 days' notice at 103¾ for the first year and decreasing thereafter. Non-refundable for 5 years at a lower interest rate than 4.687%<br>For sinking fund starting in five years at 100 | On 30 days' notice at 105.78 for the first year and decreasing thereafter. Non-refundable for 5 years at a lower interest rate<br>Special redemption price if properties taken by eminent domain, starting at 100.77 for the first year and decreasing thereafter |
| Sinking Fund | Starting after three years at $1,500,000 annually, so as to retire 81% of the issue by maturity<br>At the company's option, it may retire for sinking fund an equal additional amount each year | Starting after five years at $1,500,000 annually at an increasing rate, so as to retire 80% by maturity<br>At the company's option, it may retire for sinking fund an equal additional amount each year | None[1] |
| Limitation on Additional Debt | Additional bonds may be issued up to 75% of capital expenditures, provided consolidated earnings in a recent period cover interest charges 1½ times | Additional bonds may be issued up to 66⅔% of net bondable property | Additional bonds may be issued up to 66⅔% of net bondable property, provided earnings in a recent period cover charges on this and prior liens 1¾ times |
| Restriction on Dividends | Dividends on common can be paid out of earned surplus accruing subsequent to the sale of this issue plus $50,000,000 | Dividends on common can be paid out of earned surplus accruing subsequent to 1955, plus $50,000,000, plus sale of stock after that date | None |
| Modification of Indenture | | With consent of 66⅔% of the principal amount, but does not apply to maturity or interest rate | With consent of 66⅔% of the principal amount, but does not apply to maturity or interest rate |

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[1] Electric company mortgage bonds generally have some form of sinking fund, most of which can be satisfied with property additions.

latter acts in behalf of the lenders who supply funds for paying the manufacturer. The agent receives serial payments from the user to provide funds to cover the payments on the certificates. At times lending institutions act as their own agents. Upon final payment, title passes to the user. This is known as the Conditional Sale Agreement method, and most often the financing is for the full cost of the equipment and is privately arranged.

2. Title to the equipment is passed to a trustee by the manufacturer. The equipment is leased to the user, with the lease payments sufficient to take care of the initial down payment, serial payments, interest, etc. Certificates issued by the trustee are sold in the market through investment bankers to provide the funds to pay the manufacturer. Upon final payment, title passes to the user. This may be referred to as the Philadelphia plan and is the one most frequently used today.

Under each of the plans the user agrees: to keep the equipment in proper condition, insure it, pay taxes, pay for any claims which may arise as a result of its use, provide necessary evidences of the trustee's ownership, etc. This type of financing, as it exists today, is made possible by provisions in laws affecting the companies which rely on it, such as the Interstate Commerce Commission Act for railroads and bus companies, the Admiralty Act for steamship and barge companies, and the Transportation and Airport Act for airlines. If there is a default, these laws give the trustee or holders of equipment obligations the right to enforce their lien on the property and seize it, wherever it is located. This enhances the position of the security holder.

### *Lease Financing*

Lease financing is included at this point, because it has one characteristic which makes it more akin to a mortgage type of financing than to other forms of debt. In a mortgage, the investor has a hold on the property, and in most forms of mortgages, a defeasible title is transferred to the lender or the trustee until payment. In lease financing all title is given up. You may be surprised by this comparison, but the reasons will be discussed subsequently. At least, it is fitting that lease financing come after equipment obligations, because, as you have noted, one form of equipment certificate is based on a lease. Of course, such financing is, in the end, different from an ordinary lease.

Quite a hullabaloo has been kicked up about the subject of leasing. This is surprising, because it has been a method of financing which has been used for many years. However, its use in broader fields in recent years seems to have given it the appearance of something quite new. Controversy has developed and some misconceptions seem to have crept in. For this reason, we will give it somewhat more space than some of the other forms of financing.

Lease financing may take one of two forms:

1. A straight lease of property or equipment from a party whom we will call the investor for financing purposes.
2. Original ownership of property or equip-

EQUIPMENT TRUST CERTIFICATES

| *Advantages* | *Disadvantages* |
|---|---|
| 1. May represent the only means of financing available to a company which has a poor credit standing.<br>2. Because of the strong security position, the interest rate may be lower than could be obtained by other means of financing. | 1. The paydown is rapid and new financing is generally required for additional equipment. If a company's credit is strong it might be less burdensome and expensive to use a more permanent form of financing which will provide a pool of funds to buy equipment. |

> ment and sale to an investor who leases it back. In some instances, there may be a dummy company to hold the property as a mechanism of financing.

The party we have termed the investor for financing purposes is the lessor. He may render other services in addition to financing.

A third party may be brought in as the investor by means of an assignment.[5] The form of the lease does not greatly affect the principles, which we will discuss now.

With respect to financial policy, we are primarily interested in those leases which may be handled by an alternate method of financing. In some instances, such as the following, a company will decide to lease for reasons other than financing:

> A retail store which wishes to open a branch in a large building and occupy only a small part would probably not wish to go to the trouble of financing the whole building. The same may apply in a shopping center. Equipment may be available only on a lease basis.
>
> A company may find that lease financing is the only means by which it can obtain capital because of poor credit standing. For example, a lease of salable equipment may put the investor in such a position that he could recover his investment if the company went broke, or the investor's position may be so strategic that the company would wish to pay his obligation above others. This is akin to the position of a holder of equipment trust certificates. Under such circumstances, leasing may be quite costly but necessary.
>
> A company may find that it could raise more money or command more equipment by means of a lease than alternate methods, and have to resort to leasing for either one of these reasons.
>
> In government contract work, lease payments may be allowed as a cost, in a cost plus contract, and thus leasing of equipment, etc., may make it possible for a company to be assured more readily of getting back its capital cost. By leasing equipment under leases tailored to the term of the contract, the company can charge off the full cost of the equipment to the government. If it were owned, the equipment would have to be depreciated over its normal life.
>
> If property or equipment is only needed for a brief period, or it is expected that the value will decline rapidly in the near future, a short-term lease may prove to be the best solution.
>
> In some instances, sale and leaseback may be used for the purpose of realizing a capital gain or loss.

From here on we will be concerned with situations in which a company has a free choice of other methods of financing. When that choice exists, a company should carefully analyze all possible methods and correctly compare their relative advantages and disadvantages.

Confusion arises about lease financing because it involves much more than is encountered in an ordinary type of financing, and it is not readily understood. The problem of understanding leasing seems to center on four points:

1. Some simple but patent misconceptions as to what lease financing may accomplish which are bound to lead to erroneous conclusions if they are not corrected. The principal misconceptions are two in number: (a) Leasing produces, out of nowhere, money that a company can use

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[5] The following is an example of how a third party may enter the picture: *A*, a land owner, wants a service station on his land. *B*, an oil company, builds the station. *A* executes a note secured by a mortgage to *B* for the value of the building. Since the oil company, *A*, wishes to finance the project, the note and mortgage (and a corresponding part of the rental) is assigned to a third party *C* for an amount equal to the cost of the building. Here a third party has come in as an investor to the extent of the cost of the building. *A* leases the entire unit including the land to *B*. Part of *B*'s payment goes to pay interest and principal on *A*'s note which *B* holds for the cost of the building. To the extent of the value of the land, *A* is an investor. When the note is paid, *A* owns the entire unit and a rental renewal is worked out with *B*.

in its regular operations, such as for inventory, etc., which is a fast turnover type of asset as compared with the type that is leased. (b) Leasing in itself will take a company out of the business of handling the type of asset it leases.

2. Some disagreement as to what lease financing represents, that is, whether or not it is a form of debt. What you decide on this point will have an important bearing on much of your reasoning and your final conclusion.
3. A failure to decide on the merits of each element of lease financing separately. If the elements are jumbled together, no logical effort can be made to arrive at a sound conclusion.
4. A tendency to slough off a complete analysis of the ultimate effects when the lease expires, as compared with the effect if property were owned.

So that we will be talking about the same thing, we will use an example to explain the two misconceptions mentioned above under the first point. Leases may contain many complicated provisions, but for our present purpose, our example will be kept simple. It will not invalidate the explanation.

Company *A* owns a building worth $10,000,000, which will wear out in ten years. It transfers ownership by sale to an investor for $10,000,000. The investor immediately leases it back to the original owner for $1,000,000 a year plus the equivalent of interest for a period of years. As a result, the company occupies the building but no longer owns it; in its place, it now has $10,000,000 to use as it sees fit. It pays back the money with the equivalent of interest over the period of years during which it is allowed to use the building under the lease. In diagram form, these transactions are as shown below.

LEASE FINANCING

| *Company A* | *Investor* |
|---|---|
| Building is owned by company at start. | Investor gets title and pays the sale price. |
| Company gives up title and gets $10,000,000 from sale. | Investor receives $1,000,000 per year plus an amount equivalent to interest. |
| Building is leased back to company, which pays lease charges. | |
| Company uses the building without change, during the life of the lease. | |
| At the expiration of the lease, the company no longer has any right to the building. | |

The same thing could have been accomplished by financing without resort to the lease form. The company could have arranged the sale of a debt security to the investor for $10,000,000 with payments of interest and principal over the life of the building. The company would get the same $10,000,000 to use as it saw fit, and it would pay it back at the rate of $1,000,000 per year over a period of years plus an amount of interest. At the end, it would have clear title to the property and could continue to use it without any further payments.

The two misconceptions which this example should dispel are: 1. that through leasing, a company can raise money on real estate or other property to use in line with its regular operations; 2. that the company can concentrate on its operations rather than be in the real estate business. Each of these is discussed below.

1. *A company can raise money from real estate or other property for use in its regular operations.* In the above example, the company did not raise any more money by lease financing than it could have by debt financing. It would have received $10,000,000 in each case. This is so ridiculously simple that it is hard to see how anyone could be confused

about it; yet some people seem to have the idea that lease financing produces funds out of nowhere. In lease financing you give up an asset which could otherwise be used as a basis for some other medium of financing. While no obligation is recorded on the liability side of the balance sheet in a lease arrangement, the company takes on a fixed charge equivalent to that for another type of debt financing. Lease financing is merely one means of raising capital. As was mentioned above, there may be situations in which more money may be raised through lease financing than by sale of a debt security, but this is not important as far as our present example is concerned.

2. *A company can concentrate on its operations rather than be in the real estate business.* This is not a good answer. It still uses the building just as if it were owned. As far as use is concerned, there is no change whatever. None of the supposed disadvantages of ownership is eliminated by the mere act of lease financing itself.[6] If anyone thinks that he is getting out of the real estate business merely by the process of lease, he should realize that the problem of price and terms of lease are just as important and as much a part of real estate as buying it outright. Furthermore, in a net lease all the burdens of ownership, maintenance, insurance, taxes, operation, etc., continue to be borne by the lessee. If part of the assets of a company are removed and fixed charges and depreciation replaced with rental charges, some ratios such as turnover of capital may look tremendously improved, but this is merely due to a change in the figures included in the denominator. This is more of an accounting change than any change in substance. It is strictly a matter of leverage.

It makes no difference as far as the above two points are concerned whether the property or equipment was originally owned, then sold and leased back, or whether it was leased in the first instance. The results are the same.

If we are together on these misconceptions so that we do not allow them to confuse our thinking, we can proceed.

Analysis of a lease form of financing *vs.* other methods may be complex, depending on what the lease covers. Some types of lease only include financing charges. They are known as net leases, as referred to above. The company using the property has to maintain, insure, pay taxes, be responsible for law suits, etc. Other types of leases may include payments to the lessor for one or more of these or other items. This adds to the complexity and makes the decision whether or not to lease a more difficult one. It is necessary to weigh the financial and the non-financial considerations separately, and also to analyze each point under them separately.

First, we will go over the financial considerations in comparing lease financing with other methods of financing. In Chapter X, "Profit Goals—Cost-of-Capital," it is explained that the profit goal must be based on a composite cost of all outstanding capital, because we are seeking a rate which will be applied on the asset side of the balance sheet. However, in comparing the cost rates of securities we are not concerned with the composite cost. We must compare the rates of similar types of securities. Therefore, we must start by coming to a conclusion as to what is the nature of lease financing.

The author believes that lease financing is clearly a form of debt or at least is like debt. As far as costs are concerned, it should be compared with other forms of debt. As has been noted above, some people are violently opposed to this idea. You must make up your own mind on the subject, because it will determine with what you compare the cost of a lease. You will have to be definite and call a spade a spade.

Here are the reasons for my point of view on lease financing:

1. A lease is an obligation to pay a fixed amount annually. If not paid, the property under

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[6] As was pointed out at the start of the lease discussion, we are considering lease financing where it is an alternative for another form of debt financing. We are not concerned with situations where, as a matter of business judgment, it may be wise to make a short-term lease.

lease will be lost to the company regardless of the wishes of the common stockholder. The lessor has a claim—a valid, legally enforceable claim for the full lease except in bankruptcy. The claims of the investor in the lease are far superior to those of either a preferred or common stockholder.

2. Some people suggest that because statutory limitations generally restrict a lease claim by a maximum of one year's rent in bankruptcy and three years rent in reorganization, if the trustee rejects the lease, it is dissimilar from a credit claim. However, when a default occurs, the company loses the property. This could not occur if a lease had the characteristics of any form of equity. Furthermore, non-payment of a lease may lead to bankruptcy just as any other liability.
3. Rent is said to be an operating expense and not a financial fixed charge such as interest, and there are other operating expenses equally as fixed or burdensome as a lease rental. However, many operating expenses are not a long-term obligation as is a lease, and flexibility is generally lacking in lease payments as far as minimum charges are concerned. Furthermore, if we compare one company with another, we would wish to compare one type of operating expense with another of like character; the same idea applies to financing costs. The charges for a lease certainly could not be compared with any payments on equity. Furthermore, some laws affecting investors require them to measure a company's credit by treating lease rentals as a fixed charge. In any event, even if the law did not so provide, any astute investor would do so.

No matter how you slice it, a lease is an obligation to pay a fixed amount, more similar to a form of debt than equity, and it is therefore with other media of debt financing that the cost should be compared.

In fact, a lease is a non-callable form of debt, at the expiration of which the lessee no longer has the asset used as a basis of financing. The loss of any remaining value is a cost compared with straight debt financing. If the lessee is able to retain use of the property by payment of a renewal rental, etc., at the expiration, such a charge[7] is a penalty as compared with the other form of debt securities. To the extent that a lease is cancelable, it takes on the form of a callable debt security. If, in addition to payment of the balance of the principal due, a penalty is required in order to retain the property, such a penalty is analogous to a call premium on a bond.

For a net lease, the payments to the investor cover just two items—return of capital and interest for use of money. This is similar to the simple example we used to explain what was meant by a lease. In order to make a cost comparison, you must break down the lease payments into its two components—return of capital and interest. For example, let's take a constant lease payment for lease of a property worth $10,000,000. The lease rental represents a 10% constant payment. From the appropriate interest tables, it can be determined that the interest rate component would be 5¾%. This would be equivalent to owning the property, depreciating it so as to write it off in 15 years and financing it with a $10,000,000 debt security with a constant 10% payment, including interest of 5¾% on remaining balances. In such a simple setup you can make a direct comparison of lease financing with conventional debt financing.

First, it is necessary to decide whether the interest component in a lease is greater than you would pay with some other form of debt financing. You must make allowance, either mathematically or on the basis of judgment, for any difference in the length of maturity, and in repayment schedule. A factor that may bear directly on the cost comparison with interest on other forms of debt is the possible additional bank balances which may have to be carried if a bank indirectly provides funds for lease financing. The money for those deposits will have to be provided by some form of long-term capital and the charges on the capital added to the cost.

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[7] If the renewal rental is low in relation to other comparable space available at the time, the lease then may be an asset. However, whatever the renewal rental charge, it would be in addition to what the company would have had to pay had it done straight debt financing.

There are some other costs which may be considered as a part of financing costs—for example, the finders fee, if an agent arranges the lease. This is comparable to the investment banker's commission in a security sale. If there is a third party in a lease deal there may be an additional fee, which is rolled into the rental charge. In security financing as well as lease financing there may be a commitment fee, if the money is not to be used immediately.

Generally, on the basis of financing costs alone, a lease form of financing is a more expensive method than other forms of debt[8] if a company is in a position to do as it wishes. Therefore, under such circumstances, the use of a lease must be based on some non-financial factors. Now we will turn to questions of a non-financial nature.[9]

Even a net lease which does not include any other service will necessitate some further indirect financial considerations. First among these is the advantage of ownership over leasing at the expiration of the lease, which has already been alluded to. A lease will generally contain a provision permitting the company to renew the lease for a limited time by some additional payment, or there may be a repurchase option. As has already been pointed out, such payments are in the nature of a penalty when comparing leasing with other forms of financing. While a lease may not expire for twenty years and the expiration may seem remote when the lease is signed, nevertheless, a careful analysis must be made of what may happen under varying circumstances at that time, such as during a period of inflation. Which method, lease or ownership, will permit the company better to preserve its interest in a valuable asset at the end of the lease? On this point, if there are many non-depreciable assets involved, the scales may tip in favor of ownership. The importance of residual value will depend to some extent on the time element. Residual value decreases with time because of the present value of money factor.

Next in the cost comparison calculations comes an analysis of tax savings. If the property leased is 100% depreciable, then the principal component in the rental charges probably will be about equal the depreciation charge if the property were owned. Since they are equally deductible for tax purposes, the only difference lies in the timing. If the lease period is shorter or if the amortization under one is greater than the other in the first years compared with the later ones, the company may have some cash temporarily at its disposal. Its value must be measured on the basis of the present value of money. The more rapid depreciation applicable to owned property under the sum of the digits or declining balance methods allowed for Federal Income Tax purposes, has generally tipped the scales against leasing as far as the tax factor is concerned.[10] If a non-depreciable asset is involved, then a lease may provide greater tax savings, but this may be offset by the fact that the company has to give title to that asset and cannot benefit equally as well from appreciation in value of the asset.

It is sometimes contended by those favoring a lease arrangement that a company is in a more flexible position if it is not burdened with the ownership of the property. This involves four questions: Can the lease be changed or eliminated as easily as another form of debt? Is the company as free to use the property, alter or improve it, or sell it with a lease as with another form of debt? Are there any restrictions in the lease regarding such matters as building of branches which might compete with the leased properties? What are the restrictions on mergers and consolidations? Circumstances will decide, but a company is generally freer to do as it pleases if it has the ownership.

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[8] For example, a representative of an equipment leasing company has stated that its effective interest rate is about 2% over the rate at which a company could borrow directly. It is that company's contention that it can more than make up the extra financing cost by better buying and selling equipment. It has been stated that the effective interest charge alone for a long-term lease might be ½% more than an equivalent bond rate.

[9] For a regulated company such as a utility, one disadvantage of a lease type of financing is the fact that leased property cannot be included in rate base.

[10] In certain special situations a company may wish to realize a tax loss on property through sale and leaseback. However, you must be careful to ascertain that the method you use will be acceptable to the Bureau of Internal Revenue so that you will not have a tax suit on your hands.

If a lease is not solely a net lease, in addition to the above factors you will have to analyze separately the advantages and disadvantages of each type of service that may be provided. This may involve such questions as: Can use of the property be obtained cheaper through lease or ownership? If equipment is involved, can a better secondhand sale price be attained by a lessor or owner? Is there great danger of obsolescence, and if so, will the lessor assume this risk? What is the use factor, and can a savings be realized by lease which would tie in with use? Each service which may be included will have to be studied on its own merit, considering cost and alternatives.[11] This may include maintenance or servicing in one way or another, accounting storage and a number of other services, depending upon the nature of the property.

Is there less apparent burden with a lease than with equivalent debt?

Here is one factor which has not yet been discussed. How do investors evaluate a lease *vs.* a debt obligation in assessing the effect on the other securities of a company?

One of the tests for debt is the percentage that it represents of total capital structure. Since lease financing does not appear on the balance sheet, it may not be considered by some investors as being as burdensome as an equivalent amount of debt. This may be an advantage of lease financing. However, it would not be expected that most experienced, highly skilled, large institutional investors would make any real distinction. The reason for the distinction in the past by some investors may be the difficulty of analyzing leases from the information reported by companies. It is reasonable to expect that investors will require more and more complete information on leases. Some people contend that complete revelation of facts requires the company to show the capitalized equivalent of leases.[12] While this approach will undoubtedly be fought vigorously by some, it does not seem to be an unreasonable figure to report, at least in the year that the lease is consummated.

Certainly, if a company believes in the principle of keeping investors fully informed, it will wish to report lease obligations so that the investor can make whatever calculations he chooses, to assist in his own analysis. If a lease is a net lease, that is, with no payments except for principal and interest, a footnote to the income statement giving the annual charges and the maturity of the lease will make it possible for an investor to arrive at an approximate capitalized amount if he wishes to do so. For example, the capitalization multipliers to apply to annual lease rentals with 5½%, 6% and 6½% interest rates calculated monthly for level payment leases would be on pg. 117.

If the leases include items other than capital charges, the footnote should separate these capital charges on an approximate basis. A company may find that failure to provide complete disclosure may work to its disadvantage, because some investors may apply a capitalization ratio to the entire charge.

While this idea of hiding debt through lease financing may be some advantage in favor of lease financing today, it would seem to be a questionable one for a company to use as its basic reason for the lease method. Such an advantage depends on investors' failure to do a complete analysis. In any event, a company certainly should not try to take advantage of the lease method by failing to reveal adequate information. That is totally out of step with the idea of a sound investor relations program as discussed in Chapter IX. This is also a problem for the accountants in the certification of financial statements and full disclosure.

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[11] A partial check list of factors to consider in leasing equipment, as suggested by a representative of a leasing company, is as follows:

1. Lowest possible rates, interest and fees, 2. Advance knowledge of costs and expenses, 3. The right to specify types of equipment meeting your requirements, 4. The right to specify replacement frequency, 5. Delivery of equipment from within the area of need, 6. In the case of maintained equipment, full monthly accounting of all charges, 7. Depreciation period acceptable to the Internal Revenue Service, 8. Consultation at no additional charge, 9. Buying and selling at no extra fee, 10. The right to 100% of any profit on trade-in or other disposition, 11. A plan tailored to your needs.

[12] Some companies, *e.g.*, Comptometer Corporation, Continental Airlines, Inc., and Textron, Inc., show a capitalized amount for leases in a footnote.

CAPITALIZATION RATIOS[1]

| *Maturity in Years* | *5½% Interest* | *6% Interest* | *6½% Interest* |
|---|---|---|---|
| 1 | 1.0 | 1.0 | 1.0 |
| 2 | 1.9 | 1.9 | 1.9 |
| 3 | 2.8 | 2.7 | 2.7 |
| 4 | 3.6 | 3.5 | 3.5 |
| 5 | 4.4 | 4.3 | 4.3 |
| 6 | 5.1 | 5.0 | 5.0 |
| 7 | 5.8 | 5.7 | 5.6 |
| 8 | 6.5 | 6.3 | 6.2 |
| 9 | 7.1 | 6.9 | 6.8 |
| 10 | 7.7 | 7.5 | 7.3 |
| 11 | 8.2 | 8.0 | 7.8 |
| 12 | 8.8 | 8.5 | 8.3 |
| 13 | 9.3 | 9.0 | 8.8 |
| 14 | 9.7 | 9.5 | 9.2 |
| 15 | 10.2 | 9.9 | 9.6 |
| 16 | 10.6 | 10.3 | 9.9 |
| 17 | 11.0 | 10.6 | 10.3 |
| 18 | 11.4 | 11.0 | 10.6 |
| 19 | 11.8 | 11.3 | 10.9 |
| 20 | 12.1 | 11.6 | 11.2 |

[1] As prepared by the Financial Publishing Company, 82 Brookline Avenue, Boston 15, Mass. The figures are the reciprocal of the constant percentage payment rate to provide interest and principal payment at the particular interest rate in the number of years indicated. They can be calculated from tables giving the present value of annual payments of $1.00 at a certain interest rate over a period of years. The above table provides for interest payments on a monthly basis. In order to capitalize the lease rental, multiply the annual rental by the appropriate capitalization ratio. For example, if the lease rentals were $1,000,000 annually and the interest component of the lease was 6%, with the lease maturing in 20 years, multiply by 11.6 to get an equivalent principal of $11,600,000.

The following paragraphs give a summary view of lease financing:

On the basis of financing costs alone, lease financing is generally a more costly form than other types of debt financing.

Correct analysis of lease arrangements with alternatives may involve some rather extensive tables over the life of the lease with allowance for the present value for differences in the flow of funds. However, it is not a hopeless task, provided each item is studied separately and correct comparisons are made with the right alternatives.[13] Any other approach will be making a decision blindly.

In Chapter X on profit goals, there are a few pages on the use of the discounted cash flow method of analysis for determining the profitability of a new project. Briefly discussed is the importance of the correct approach to capital raised through lease financing. If handled in the wrong way, totally ridiculous results will be obtained.

While the question of lease financing in the first instance is one of costs based on adequate figures with proper comparisons, judgment must be applied in many respects. A lease may extend over a period of years during which circumstances may change substantially and call for judgment on such questions as: Will a lease or ownership be more flexible? What will permit the greatest recovery of residual value? Can you and should you try to gain by lease over debt because lease does not appear on the balance sheet? Can you, in good conscience and in duty to your security holders, fail to give complete disclosure about leases? That is a good point on which to leave this type of financing.

### *Debentures*

Many industrial companies use debentures as their principal form of funded debt. The indenture for a debenture is of necessity an extensive document, as is a mortgage indenture exclusive of the provisions covering the mortgage alone. If a debenture is sold publicly, it will have to include provisions required by the Trust Indenture Act of 1939. It will cover such items as the form of and denominations of the bond; definitions, registration and transfers; long lists of covenants; redemption provisions, sinking fund provisions, remedies in event of default, provisions regarding the trustee and his duties; effect of merger, consolidation, transfer or lease; supplemental indentures; debenture holders' lists and reports by the company and trustee, etc. Much of the voluminous material is "boiler plate," but must be included. The important parts are the provisions affecting the credit.

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[13] If you have trouble in making calculations where present value is a factor, you may wish to obtain assistance from the Financial Publishing Company referred to in the footnote to the previous table on capitalization ratios. They have actuaries who are familiar with this type of calculation and their fee is nominal. Do not ask them to perform the analysis itself. They do not purport to be financial experts; they are financial actuaries.

### Debentures in Place of Mortgage Bonds for Senior Security

| *Advantages* | *Disadvantages* |
|---|---|
| 1. May be no difference in rating or cost in most instances. | 1. May have some tight restrictive provisions. |
| 2. Eliminates the necessity to pledge property to secure the issue, and the ensuing expenses. | 2. If mortgage bonds are used for the senior obligation, then debentures may be used as a second form of debt financing. When debentures are the senior obligation, another layer of debt will have to be in the form of a junior debenture. |
| 3. May be more flexible in merger or consolidation than a mortgage bond. | |

### Debentures in Addition to Mortgage Bonds

| *Advantages* | *Disadvantages* |
|---|---|
| 1. Cheaper than preferred stock, but this is an incorrect comparison, as is explained elsewhere in Chapter II. | 1. Affects debt limit. |
| 2. May be a necessary form of financing in an emergency, and might be reserved better for that purpose. | 2. May restrict unsecured borrowing limits. |
| | 3. May prevent use of convertible debentures. |
| | 4. If it represents much over 7% of the total capital structure, it may reduce the rating in the mortgage bonds. |
| | 5. Generally requires heavy sinking fund. |

### Subordinated or Second Debentures

| *Advantages* | *Disadvantages* |
|---|---|
| 1. May have to be resorted to in an emergency, if other media of debt financing are prevented by restrictive provisions in the indenture, etc. | 1. The use of this type of security is generally an indication of financial weakness in an industrial company and should be avoided if possible. |
| 2. For special types of companies, such as finance companies, it may be an appropriate means of raising debt capital. | |

A well drawn indenture for an unsecured debt can generally place the investor in almost as strong a position as a mortgage indenture through various protective covenants covering maintenance of assets and handling of them in event of merger, sale, etc., and by restriction on the sale of additional debentures unless credit ratios afford adequate protection to the holders, etc. The types of provisions that might be included were discussed under mortgage bonds. Since a debenture does not have a lien on property, there will have to be a provision preventing other issues from grabbing on to the property, unless the debentures are equally secured. This is referred to as a negative pledge clause. Furthermore, provisions as to the effect of liens and dissipation of assets in event of merger, consolidation or sale will have to be tightly drawn.

When an original debenture is formed, the indenture can be drawn so as to permit subsequent issues under the same indenture by means of a supplemental indenture. This will save money and effort over the alternative of an entirely new indenture. However, it calls for care and foresight in the drawing of the original indenture. Provided the terms of the original debenture issue will permit it, a junior debenture may be issued and even a junior to the junior issue. However, it would certainly be advisable to avoid such financing except in a dire emergency.

Given on page 118 in outline form are advantages and disadvantages of three possible situations in which debentures may be used.

Three things to keep in mind with regard to debentures might be summarized as follows: 1. They should not be so used as to restrict seriously the availability of unsecured bank credit; 2. The debenture slot should not be so used up as to prevent the employment of a convertible debenture in an emergency; 3. If mortgage bonds are the principal form of a company's debt, the debentures might be reserved for an emergency, so that additional debt could be issued temporarily with a heavy sinking fund and not disturb the credit rating of the principal form of debt.

Examples are given on page 120 of a few terms in the debentures of three companies which used debentures as their senior debt security. They are not representative of the correct legal interpretation because they are summarized to assist the reader in visualizing their significance.

### *Long-Term Notes*

In some instances, particularly in a private deal, notes may be used rather than a debenture. A note replaces the bond, and an agreement replaces the indenture. The terms are less elaborate than in a debenture bond offered publicly. A trustee is generally not used. Such a type of unsecured funded debt is most likely to occur when there is a private deal and only one or a very few investors.

It is, of course, possible for there to be a trustee in a note form of financing and a public sale just as in the case of a debenture, but then all the requirements of a debenture bond would have to be fulfilled, so that the difference would be in name only.

LONG-TERM NOTES

| *Advantage* | *Disadvantage* |
|---|---|
| May eliminate the expense of a trustee, and some of the elaborate legal work of a debenture bond with all the appurtenances. | Largely limited to special situations where the investors have no special interest in having the security in a form suitable for resale, and for which, in most instances, repayment is expected in a relatively short period. |

### *Term Bank Loans*

Bank loans which mature after one year are known as term loans. If they are just over a year they may be, for all intents and purposes, the same as current loans. However, when banks have had excess funds, they have made loans for as long as ten years on a serial basis. The repayment schedule may include a balloon or large payment at the final maturity. The length of maturity that can be obtained will depend on the willingness of the banks to lend. Such loans are truly a part of funded debt. Other types of bank loans which fall in the category of term loans are commitments with the right to borrow over a period of time, with repayment to come within some such

## (DEBENTURES)

| | *Steel Company* | *Tobacco Company* | *Telephone Company* |
|---|---|---|---|
| Dated | April 1959 | June 1959 | April 1958 |
| Interest Rate and Maturity | 4.35% due 1984 | 4⅞% due 1979 | 3⅞% due 1993 |
| Principal Amount of Issues | $75,000,000 | $40,000,000 | $30,000,000 |
| Composite Bond Rating | *Double A* | *Single A* | *Triple A* |
| Offering Price | 100 | 99 | 101.056 |
| Redeemable | On 30 days' notice, at 104.50 for the first year and decreasing thereafter | On 30 days' notice, at 103⅞ for the first year and decreasing thereafter | On 30 days' notice, at 106.056 for the first year and decreasing thereafter |
| | Non-refundable for five years at a lower interest rate than 4.35% | Non-refundable for five years at a lower interest rate than 4.95% | |
| | For sinking fund starting in four years at 100 | For sinking fund starting in six years at 100 | |
| Sinking Fund | Starting after four years at $1,875,000 and increasing in amount so as to retire 95% of the issue by maturity | Starting after six years at $2,000,000 so as to retire 70% of the issue by maturity | None[1] |
| | At the company's option, it may retire for sinking fund an equal additional amount each year | At the company's option, it may retire for sinking fund an equal additional amount each year | |
| Limitation on Additional Debt | No limit on additional debt unsecured, or secured debt as long as these and similar debentures are equally secured | No additional debt unless consolidated assets, excluding current assets, would be at least twice consolidated funded debt. | No limit on additional unsecured, or secured debt as long as these and similar debentures are equally secured |
| | Additional restrictions cover:<br>creation of liens, sale of securities by subsidiaries, lease-back financing, etc. | Additional restrictions cover:<br>creation of liens, sale of securities by subsidiaries, lease-back financing, etc. | Additional restrictions cover:<br>consolidations, mergers, sale of property, guarantee of another company's debt, etc. |
| Restriction on Dividends | None | Dividends on common can be paid out of earned surplus accruing subsequent to the sale of this issue plus $20,000,000 net proceeds from sale of stock after that date | None |
| Modification of Indenture | With consent of 66⅔% of principal amount, but does not apply to maturity or interest rate | With consent of 66⅔% of principal amount, but does not apply to maturity or interest rate | With consent of 66⅔% of principal amount, but does not apply to maturity or interest rate |

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[1] This debenture issue was the company's only form of long-term debt. Generally, debentures of utility companies, particularly if they are junior to a mortgage bond, contain a sinking fund.

period as five years from the date of the agreement. There generally will be a fee of ¼ to ½ of 1% on the unused portion of the commitment. A commitment may include a revolving feature, which permits the borrower to borrow, repay and borrow again within a specified time. The interest rate on a term loan will generally be at some premium over the prime rate. It may be fixed or vary with the prime rate. An added cost of such loans, as compared with other types of loans from non-bank lenders, is the cost to carry the deposit account that will have to be kept as a compensating balance.

Term bank loans will generally require a loan agreement. The extent of the restrictions will depend on the company's credit standing. They are relatively flexible with respect to repayment prior to maturity, because banks are generally willing to permit repayment without any call penalty, as long as the proceeds for such purpose are not obtained from a loan from another bank.

If a company has a good credit standing and has carried good deposit balances, it is in a strong bargaining position in arranging such a loan, as compared to loans from other institutional investors. Because of the deposit account and other possible banking business, a bank will have a desire to please a customer. This element is not present with other types of lenders.

The danger in term bank loans lies largely in their excessive use to finance a long-term capital need with a relatively short maturity. As pointed out in the previous chapter, when a term loan is arranged, a company should have clearly in mind how it will be repaid at maturity. It should consider whether it might not be better off doing long-term financing in the first place.

### *Income Debentures*

The interest on income debentures is paid only if earned, under certain circumstances, as preferred stock dividends; yet income debentures have the advantage over such issues in that the interest is deductible for tax purposes, provided it is properly drawn. In other words, they appear to be similar in nature to preferred stock; yet they have the advantage of the interest being deductible for tax purposes. This has led to the suggestion that income debentures should be substituted for preferred stock.

INCOME DEBENTURES

| *Advantages* | *Disadvantages* |
|---|---|
| 1. Apparently similar advantages as preferred stock in that interest is paid only if earned. | 1. Restrictive provisions may be required by buyers of the security which give it all the disadvantages of debt, in that it affects "borrowing reserve" and "financial insurance." The advantages may be only apparent, and a lower rate might be obtained on a straight debenture. |
| 2. If properly drawn, the interest is deductible for tax purposes. | 2. May indicate a company's weak financial standing and inability to finance in a more conventional manner. |
| 3. If a company is in dire financial condition, it may be necessary to resort to this type of financing. | |

On the surface, income debentures do seem to have the edge on preferred stock, but if you study the terms carefully, you will find that there are many hookers which give them many of the disadvantages of debt. They may affect borrowing reserve because of debt restrictions. Their terms are actually more onerous than those of preferred stock and thus are more of a burden as far as common stock is concerned. Some contain a provision to the effect that if the interest is declared to be not deductible for tax purposes, it becomes fixed.

Thus they should be included in the debt category and are by no means any panacea. You can't have your cake and eat it too. They should not be used under any circumstances unless every one of their provisions is carefully evaluated and weight is given to their effect on the principles of sound financial policy. It would seem that their use might be considered an exception rather than the rule.

### *Other Forms of Debt Financing*

Capital may be raised with other forms of debt financing, some of which appear as unfunded debt but, because of regular renewals, actually perform the function of providing long-term capital. Included are such media as commercial paper, loans on warehouse receipts, receivable financing in its many forms, acceptance financing of goods in transit by a bank and oil lease financing under ABC form. Some of these types of financing may meet the needs of a particular company.

Any valuable asset or regular source of income represents the basis for a possible medium of financing, but, of course, not necessarily an appropriate medium. A company should know about all of the various media of financing that might be available to it and should study them carefully from all angles, in order to determine whether they offer any real advantage in the long run over more conventional forms of financing. Any special *form* of financing should not be allowed to obscure the essential nature of individual transactions.

Segregation of an asset in a subsidiary or in a dummy company with ownership outside of the company may represent a corporate maneuver tying in with a method of financing. As one example, a company having a large amount of receivables may set up a separate finance company; as another example, a company may form a separate company to finance its real estate holdings and lease them from that company. If a separate company is formed for financing purposes, the transaction should be analyzed from the point of view of the asset that is given up and the obligation that is assumed. You don't get something for nothing in such a maneuver, and the informed investor will not be fooled by the form.

A short-term medium of financing should not be regularly relied upon as a source of long-term capital. Hiding of debt from the balance sheet should not be the primary basis for use of a special type of financing. All forms of debt financing should be viewed from the essential aspect of maintaining a strong capital structure. When we get to Chapter X, "Profit Goals—Cost-of-Capital," you will see that it is necessary for you to be able to see through the smoke screen of any complicated type of financing in order to calculate properly and apply the Cost-of-Capital.

## PREFERRED STOCKS

We have already discussed the basic reasons for the inclusion of preferred stock in a capital structure, but a brief summary follows:

PREFERRED STOCKS

| *Advantages* | *Disadvantages* |
|---|---|
| 1. It has no maturity. | 1. If too much preferred is used, it might hurt the common equity when adverse developments are encountered. |
| 2. It preserves "borrowing reserve" and "financial insurance." | 2. It may limit unsecured borrowings or long-term debt financing if provisions are too restrictive. |
| 3. It is cheaper than common stock. | 3. It may be necessary to include a purchase or sinking fund, which will drain cash. |
| 4. Failure to meet its terms will not place the company in bankruptcy. | |

The provisions affecting preferred stock may be found in the company's charter, the by-laws, the stock certificate, and in state laws, where the company is incorporated. For certain regulated industries, there may be restrictions regarding preferred stocks imposed by regulation. The New York Stock Exchange has something to say about such matters as voting rights for preferreds listed on that Exchange. The senior security provisions may affect the preferred.

A company may have just one preferred stock issue, or there may be classes running all the way from prior preferreds to those in a junior position which may be referred to as preference stock. For example, if a preferred stock is non-cumulative, gets very limited special rights if the dividends are not paid, is not preferred over the common stock in event of liquidation, then it is close to being a common stock. A preferred stock may include some of the privileges of a common stock, if it is a participating preferred, that is, if it also participates in additional dividends with the common as earnings increase. Today it would be relatively impossible for a company to get away with issuing a preferred stock in the nature of common. And a company should avoid the other extreme of issuing a preferred which is too restrictive. Of course, if a company's back is against the wall financially and its only means of financing is by means of a preferred, it may have to accept whatever terms the investors dictate.

Ideally, if a company does use preferred, it should have one class and attempt to establish terms so that the preferred is what its name implies. It should be in a truly senior position to the common, but without terms approaching a contractual nature so that non-compliance would put the holders in a position akin to that of debt holders. Preferred stockholders are interested in preventing dissipation of assets and earnings and therefore will desire protection against some of the points discussed under protective provisions for debt. Such protection will provide some maintenance of the quality of the preferred stockholders' investment.

We will conclude these few words about preferred stocks by a summary of some of the types of provisions that might be included. They may be in a company's charter and resolutions of the board of directors. The provisions given below are taken from three actual issues which were offered publicly. They are summarized in order to assist the reader in obtaining a quick idea of their significance; for this reason, they are not all-inclusive and do not necessarily represent a correct legal interpretation of the specific provisions.

PREFERRED STOCKS

| | *Metal Company* | *Aviation and Manufacturing Company* | *Electric Utility Company* |
|---|---|---|---|
| Date of Issue | February 1956 | June 1955 | October 1956 |
| Dividend Rate | 4¾% cumulative | $4.75 cumulative | 4.64% cumulative |
| Par Value | $50 per share | No par | $100.00 per share |
| Amount of Issue | $40,000,000 | $10,000,000 | $40,000,000 |
| Composite Bond Rating | (Debt held privately.) | (Debt held privately.) | *Triple A* and *Double A* |
| Offering Price | $50.00 per share | $100.00 per share | $100.00 per share |
| To Increase Authorization of Additional or Prior Preferred | Vote of ⅔ of this preferred | Vote of ⅔ of this preferred for prior preferred and ½ for equal preferred | Vote of ⅔ of this preferred |
| Restrictions on Dividends on Stock Junior to This Preferred | No dividends on stock junior to this preferred unless all dividends and sinking fund paid on this preferred | No dividends on stock junior to this preferred unless all dividends and sinking fund paid on this preferred | No dividends on stock junior to this preferred unless all dividends paid on this preferred |

| | *Metal Company* | *Aviation and Manufacturing Company* | *Electric Utility Company* |
|---|---|---|---|
| | Dividends on junior stock can only be paid out of earnings accruing from one year prior to issuance of this preferred and then only up to 75% of earnings available | (Further restriction on dividend payments on stock junior to this preferred are only as provided in the company's promissory note agreement, which covers a freezing of prior earned surplus and maintenance of current assets at a certain level.) | |
| Redeemable[1] | On 30 days' notice, starting at $52.50 and decreasing gradually to $51.00 after 15 years<br>For sinking fund purposes, redeemable at $50.00 | On 30 days' notice, starting at $105.00 and decreasing gradually to $102.00 after the first 15 years<br>For sinking fund purposes, redeemable at $100.00 | On 30 days' notice, starting at $106.50 and decreasing gradually to $102.00 after 17 years |
| Purchase or Sinking Fund | For first five years, purchase of preferred in market at a price not in excess of $50.00 per share in the amount of $800,000 annually<br>After first five years, a sinking fund of 32,000 shares annually (If fully applicable, entire preferred paid off in 25 years.) | Sinking fund equal to 4% of total number of shares issued (Entire preferred paid off in 25 years.) | None |
| Liquidation Rights | Voluntary—at regular redemption prices<br>Involuntary — at $50.00 per share | Voluntary—at regular redemption prices<br>Involuntary—at $100.00 per share | Voluntary—at regular redemption prices<br>Involuntary—at $100.00 per share |
| Issuance of Additional Equal or Prior Preferred Stock | Pro forma coverage in a recent period, after taxes, of interest on long-term debt and dividends on this and prior preferred must be 2½ times<br>A second test also must be met: all long-term indebtedness and all this and prior preferred stock is not to exceed ⅔ of total capitalization on a pro forma basis | Pro forma coverage in a recent period, after taxes, of interest on long-term debt and prior preferred must be 3 times<br>If this test has not been met, then approval of a majority of preferred stock is required | This and all equal or prior preferred cannot be more than 75% of common equity. If this test is not met, then there must be approval of a majority of the preferred |

| | *Metal Company* | *Aviation and Manufacturing Company* | *Electric Utility Company* |
|---|---|---|---|
| | If these tests are not met, then approval by a majority of the preferred stock is required | | |
| Issuance of Additional Long-Term Debt | Same tests as for additional preferred—must include additional long-term debt in tests | Pro forma coverage in a recent period, after taxes, of interest on long term debt must be 6 times<br>If this test is not met, then approval of a majority of preferred stock is required<br>For subsidiary to incur debt, ⅔ vote of this preferred | |
| Voting Rights | None unless preferred dividends or sinking fund in arrears for a certain period, and then this preferred stock shall have the right to elect ¼ of the directors but in no event less than two | Equal, share for share, with common<br>In addition, if default in dividends on this preferred, then the right to elect ⅓ of the directors, but in no event less than two | Equal, share for share, with common. Cumulative voting applies to directors |
| Charter Alteration Affecting Preferred | Only if approved by vote of ⅔ of this preferred | Only if approved by ⅔ or ½ vote of this preferred stock, depending on the alterations | Only if approved by ⅔ vote of this stock |
| Sell (or Lease) Substantially All Property | Only if approved by ⅔ vote of this preferred | | Only if approved by majority vote of this preferred |
| Merge with an Outside Company | Only if approved by ⅔ vote of this preferred | Only if approved by ⅔ or ½ vote of this preferred, depending on nature of merger | Only if approved by a majority of the stock |
| Pre-emptive Rights | None | None | None |
| Subject to Provisions of Long-Term Debt, Existing Charter Provisions, State Laws, etc. | All provisions of this preferred are subject to any such existing provisions. Mortgage bonds contain provisions limiting purchase of preferred except out of earnings above a certain level and provided consolidated net current assets are maintained at a certain level | All provisions of this preferred are subject to any such existing provisions | All provisions of this preferred are subject to any such existing provisions |

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[1] As previously explained, the pattern today for the regular call price of a bond is to have the premium decrease at an equal annual rate to 100 by maturity. Since a preferred has no maturity, the situation is somewhat different. The regular call price may be reduced gradually until it reaches par after a certain number of years.

## CONVERTIBLE SECURITIES

Senior securities, either in the form of debt or preferred stock, may contain the privilege to convert into common stock at the holder's option. As a simple example, a convertible debenture may be exchangeable into common on the basis of one share of common stock for each $50 principal amount of debentures, or a convertible preferred stock may be exchangeable into common on the basis of one share of common for each $50 par value of preferred. The conversion privilege for a preferred may also be expressed as so many shares of common for each share of preferred. This exchange or conversion ratio, which is the number of shares of common received upon exercise of the conversion privilege, is the most important provision of a convertible issue.

A few terms of actual examples of a convertible debenture and convertible preferred stock offered by an air line and an industrial company are shown below. Don't bother to do more than glance at them. The terms of convertibles will be discussed subsequently.

*Convertible Debenture*

$46,971,000 convertible subordinated debentures, interest rate 4⅞% maturing in 20 years. Rating: *Double B*

Offered through rights to stockholders at 100, on the basis of $100 of convertible debentures for each 14 shares of common stock held.

Convertible into common stock throughout their life at $30 principal amount of debentures for each share of common stock.

Sinking fund beginning after 10 years to retire $2,800,000 annually.

Redeemable for other than sinking fund, starting at 104⅞ and decreasing gradually to 100. Redeemable for sinking fund at 100.

Price of common stock at time of offering about $27⅞.

*Convertible Preferred*

99,885 shares 5¼% cumulative convertible preferred, $100 par value.

Offered through rights to stockholders at $100 per share, on the basis of 1 share of preferred for each 38 shares of common held.

Convertible at any time prior to redemption into common at $29 par value of preferred for each share of common.

Redeemable at $105.25 for the first five years and decreasing gradually to par in 15 years.

Price of common at time of issue about $27⅞.

### *Parity Price of a Convertible*

The market price of a convertible tends to keep in parity with the market price of common stock, because of the exchangeability. Their market prices are kept in line by action of arbitrageurs, as will be explained in Chapter VI. As a simple example, if a convertible preferred stock is convertible into common on a share-for-share basis, and the market price of the common is $110 per share, the preferred will sell for about $110. The same would hold true for a convertible debenture. As the market prices of the two securities may not always be in parity for a number of reasons, it is important to have some idea of the reasons.

1. The convertible issue may have more value by itself, exclusive of the convertible privilege. For example, if $100 principal amount of convertible debentures is convertible into one share of common stock, and the stock sold in the market for $70, the parity value of the convertible would be $70. The convertible debenture might sell at a higher price because it is worth more on the basis of the interest rate and quality of the debenture itself.

   Even if there is no immediate advantage from conversion, the debenture may sell at a higher price than its worth solely as a debenture, without the conversion feature, because of the possible potential value of the conversion privilege. The convertible feature provides a call on the common stock at a certain price.
2. The convertible issue may contain special provisions which may cause it to sell at

somewhat of a discount from its parity value based on the common stock price. For example, the conversion privilege may be postponed until some future date. As another example, the conversion privilege may contain a so-called blackjack clause, which may provide for one conversion ratio prior to a certain date for part of the issue converted prior to that date, and a lower conversion rate thereafter. Because of the uncertainty that this engenders in the conversion ratio applicable to any particular part of the issue, the convertible may not sell on a complete parity with the stock.

3. Under certain conditions, a convertible debenture may sell at a premium over the parity price, due to ability of investors to borrow more on the debentures than on the stock.

In order to get some idea of how the market price of a convertible may compare with its investment worth as a senior security alone and also with its value based on the conversion feature, you can refer to studies regularly published by certain financial firms for outstanding convertibles. Two of the rating agencies publish information—Moody's Investors Service and Standard and Poor's Corporation. As an example, there are given below some of the figures which are included in the material published by Standard and Poor's Corporation for the first four convertibles in the list published April 25, 1960.[14]

*What Makes a Holder Convert?*

Since the ultimate aim of a convertible is to have it exchanged into common stock, it is necessary at the beginning to have in mind what makes a holder convert. He will convert only if the price of the convertible security is at or below parity with the price of the common stock; otherwise, if he desired to have common stock in place of the convertible, he would save money by selling the convertible in the market and buying the common directly, with due allowance for the cost of brokerage commissions, etc. For example, there would be no incentive to convert if the convertible debenture, exchangeable on the basis of $100 of debentures for one share of stock, were selling for $90 with the stock selling at $70. As the price of the stock moved up above $90, the investor might convert.

Provided conversion is worthwhile, the following conditions might lead him to do so.

1. The dividend income on the common stock is higher than that on the convertible, and the holder is willing to take the added risk in the common in order to obtain more income.
2. The conversion privilege expires. However, if this coincided with the maturity of the issue so that the holder would receive $100 at maturity for the debentures, there would be no reason to convert unless the stock was selling above $100.
3. The company forced conversion by calling the debentures. Conversion would

| | *S&P Rating* | *Conversion Price* | *Stock Price* | *Shares Per 1000 Bond* | *Conv. Value Per $100*[1] | *Invest Worth*[2] | *Bond Price* |
|---|---|---|---|---|---|---|---|
| ACF Wrigley Stores<br>4¾s, 1972 | B1 | 15¾ | 14⅜ | 63.49 | 91½ | 91½ | 106½ |
| Aetna Finance<br>5⅝s, 1975 | B1 | 15⅜ | 12¼ | 65 | 79½ | 94 | 99 |
| Aldens, Inc.<br>5s, 1979 | B1 | 37.38 | 43½ | 26.75 | 116½ | 92 | 121½ |
| Allegheny Airlines<br>6¼s, 1975 | B | 4 | 3⅝ | 250 | 90½ | 92 | 94 |

[1] Conversion Value per $100 is the worth of the bond based on the conversion price alone.
[2] Investment worth is the worth of the bond excluding the conversion feature.

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[14] *Standard Bond Reports, Convertible Bonds, Statistical Analysis,* Volume 27, #46, Sect. 11.

only occur if, on the basis of its conversion value, it were worth more than the call price. It is through the possibility of calling the issue that the company can force conversion, and then only if the parity price of the stock stays above the call price from the time the call is issued until the time the call is effective. The call notice generally is issued 30 days before the call is effective. In order to be assured of conversion upon call, the stock must be selling at the equivalent of some margin above the call price in order to provide a margin against a possible market decline during the 30-day period. The company must provide a source of cash to pay off the convertible issue if it is possible that the parity price may fall below the call price during the 30-day period and conversion does not take place.

4. Action of arbitrageurs. When the convertible issue sells about on a parity basis, if there is a small spread between the two equivalents in favor of the common stock, arbitrageurs will sell the common short, buy the convertibles, convert, and deliver that stock to cover their short position. This is explained in Chapter VI. It is through the action of arbitrageurs that much conversion takes place.

### *Misuse of Convertibles*

From the company's point of view, a convertible issue may be made to appear very appealing with the combined advantages of a senior security and a common stock. Under some circumstances, it may be a useful and even necessary type of security. However, because of the seductive nature of convertibles, they may be misused. They have distinct disadvantages. For example, the company may plan for conversion to take place by a certain date. This is subject to the whims of the common stock market and if it does not occur as hoped for, the issue may turn out to be the tail that wags the dog. This can be illustrated by a simple example.

A company's common stock is selling for $80. The company desires to have additional common stock in its capital structure, but feels that the stock price is too low at present, and would like to obtain at least $100 per share. It sells a 5% convertible debenture due in ten years, convertible into one share of common stock upon the surrender of each $100 of convertible debentures. The convertible debentures are sold at 100 because they were worth substantially that price owing to the value of the debenture exclusive of the conversion price. The company expects, because of improved earnings, that the stock will sell for somewhat over $100 within two years and that conversion will take place at that time. Let's view the picture at the end of the two years, assuming three different market prices for the common stock—$110, $90, and $150:

> Stock at $110—conversion takes place as anticipated.
>
> Stock at $90—no conversion occurs; the goal to get more common stock in the capital structure was not achieved, and the company is still stuck with the debentures.
>
> Stock at $150—conversion occurs, but contrast the market price of the stock with the $100 per share the company obtains upon conversion.

How could financing have been handled otherwise? One possible solution would have been to borrow the money from a bank for two years and then repay the bank loan with the sale of common. If the company had done this, this is how it would have fared with the three different assumed market prices for the stock, as above:

> With the stock at $110, the company would have been just as well off with the bank loan and subsequent sale of common at about $100 per share after all financing costs.
>
> With the stock at $90 after two years, the company could get the necessary equity by selling stock at a reduced price, and not con-

tinue to be stuck with the convertible debentures.

With the stock at $150, the company would be substantially better off, because it could obtain a much better price for the stock than it would have through conversion.

In other words, the company would have been as well or better off by avoiding a convertible under these assumed situations. This simple example should deflate some of the "all this and heaven too" idea that is often ascribed to convertible securities. As already stated, this is not to say that they may not serve a necessary purpose and be very useful under some circumstances, but that their shortcomings should also be understood.

### *Purposes of Convertibles*

How the convertible is designed will depend on its purpose. Therefore, we will now outline their possible purposes. Broadly speaking, the conversion feature may serve two purposes. First, it may sweeten up an offering which otherwise would be difficult to sell. Secondly, it can be used to strengthen the common stock position sometime in the future. However, these generalizations should not be relied upon in deciding whether to use a convertible. Their purpose should be analyzed in more detail, as follows:

1. *Necessity—the addition of the conversion feature to sweeten up a senior security which would otherwise be impossible to sell or difficult to sell at a reasonable price.* The investor is offered a fixed income obligation, with the additional bait of potentialities of appreciation through the conversion feature. Some investors go for such an obligation even though it is weak, provided there are real possibilities of appreciation. This purpose means an admission of financial weakness on the part of the company, but if capital is needed and this is the only way it can be obtained, the use of a convertible may be not only justified, but required.

2. *When the company has such an extensive financing program that the market will not readily absorb all the common that should be sold in order to keep the capital structure ratios in balance, and it would be unwise to postpone long-term financing.* A convertible security used for this purpose will permit the capital to be raised by means of a long-term security, and the capital structure will be strengthened as conversion takes place. In this situation, where common equity is definitely the goal, the conversion ratio should allow sufficient leeway so that the conversion privilege will be attractive enough to assure conversion.

There are a number of reasons why a large convertible issue may be more readily absorbed than a similar amount of common stock. At times, a convertible may be just what the doctor ordered as far as certain investors' desires are concerned. For example, some investment companies may not wish to buy a straight debenture or preferred stock, but at times might buy a convertible. Furthermore, some institutions might not be interested in a common stock, but would buy a senior security combining the common stock feature. In designing a convertible to meet such a market demand, it may be necessary to have in mind the special requirements of institutional investors. They may be restricted from buying common stocks, or a convertible issue if it sells primarily on a parity basis of the common stock, rather than on its worth as a senior security.

At times, the greater amount that may be borrowed by investors from banks on a convertible debenture may be important in assisting in the sale. Banks may be willing to lend more money on such a convertible than on a straight common stock, and they may be permitted to lend more by law. For example, in 1959, as provided by the Board of Governors of the Federal Reserve System, commercial banks were allowed to lend only 10% of the price for the purpose of purchasing a common stock, offered directly to the public, which was listed on the New York Stock Exchange. For similar stock offered through rights, they could loan 75% for a limited period. There were no such restrictions on loans for convertible debentures. Convertible preferreds did not enjoy this advantage.

3. *As a refunding media for existing debt, to permit a gradual strengthening of the capital structure.* This is perhaps one of the least controversial uses. No additional harm is done to the capital structure if conversion doesn't take place, unless, of course, the existing debt had a large sinking fund or serial maturity and this is not included in the convertible. Of course, the possible effect on dilution of earnings per share must be carefully analyzed.

4. *When a company needs to add common stock to its capital structure, and the market price of the common stock is unreasonably depressed for one of the following reasons:*
   a. Poor earnings, which are expected to improve.
   b. A seriously adverse stock market in general.
   c. A large block of the company's stock overhanging the market and depressing the price unreasonably.

The conversion price will be set above the existing market price of the stock at the time of the sale. It will be expected that with an improvement in the market price, conversion will take place. Therefore, the conversion price should be set so low as to assure conversion, even if the market price doesn't improve to the extent anticipated as a result of the natural optimism of the management.

This may be a good reason for the use of a convertible, but the advisability of other methods of financing should also be evaluated, such as temporary financing with a bank loan and then repayment through the sale of common.

5. *To permit a gradual dilution of earnings per share of common stock as conversion takes place rather than heavy dilution, which would result if all the common were sold at one time.* If common is needed, then the conversion price should be so low that conversion will be assured. This may result in a disadvantage in that a higher price might be obtained from the direct sale of common.

6. *If the market for either debt or preferred stock is poor and rates required to sell the securities are high, the addition of a conversion feature may be used to sweeten up the security in order to receive a lower rate of interest or dividends.* Use of a convertible for this purpose is debatable. It may be trying to slice the bacon too thin, and the company may land up with a convertible which never converts, or converts at the wrong time to cause dilution of earnings per share and thus pressure on the market price of the stock.

7. *To provide cheap money for a period while the convertible issue is outstanding, perhaps during a period when construction is taking place, and then to turn into the more costly type of security, common stock, at the end of the period, when earnings may materialize.* This also may be slicing the bacon too thin. There are other methods of handling such a situation, and they should be examined carefully.

8. *As a mechanical aid in issuing common stock with lower financing costs, since the underwriting fees are less on a convertible than on a straight common issue, and the conversion price of the stock may be set closer to the market.* In view of all the other complications of a convertible, this reason alone is hardly a good one.

9. *Present common stockholders wish to delay temporarily the addition of more stockholders in order to preserve their control.* This is a special situation and one not likely to occur often.

In some situations, a convertible may be used to accomplish more than one of the purposes outlined above, but in deciding whether to use a convertible, each purpose should be analyzed by itself with its advantages and disadvantages. This should include an analysis of how a convertible will work out with various stock prices each year throughout the life of the convertible, and alternatives for raising the capital with their advantages and disadvantages at the various stock prices. If there are alternatives and they are compared correctly, one of them may prove more advantageous than a convertible issue.

Keep in mind that if a convertible doesn't convert as planned, the company may be saddled with a senior security which might not fit into the capital structure. Furthermore, a convertible tends to exert a depressing effect on the market for the common because of the potential dilution which will result when conversion does occur. If it converts at the wrong time, there may be a depressing effect on the market when the company would prefer that this not occur, as, for example, when more common is to be offered.

A company will do well to think of a convertible issue as an emergency type of security and save this slot in its capital structure for this purpose. It is a good form of reserve type of security. A simple rule to follow is that if a company needs common stock, the market is reasonably receptive and earnings are satisfactory, it should go ahead with the sale of common and not gamble with a convertible. Anyone who has had experience trying to forecast security prices will readily admit that it is very difficult to tell at what price a stock will sell in the future. The more a company needs common stock in its capitalization, the less chance it can take on using a convertible and being subject to whims of the stock market to determine whether conversion takes place. If a company can sell stock but wishes to use convertible debentures merely because the market won't afford a high price for the stock, that company should be thoroughly prepared to justify the position that it can stand the additional debt if no conversion takes place. A company with a very conservative capitalization is in a better position to play with a convertible for other than emergency purposes. It can better stand the additional senior securities if conversion does not occur.

The purpose of the above discussion was not to discourage the use of convertibles, but only their unnecessary and inappropriate use.

### *Provisions of Convertibles*

Convertibles contain less restrictive provisions than similar issues without the conversion feature, since they are expected to turn into common. Many of the other features will be similar to those included in a non-convertible. Designing some of the terms of a convertible may be tricky because of the dual nature of the issue, as illustrated below:

1. *The conversion ratio.* Much has already been said on this point. At the start it was explained that the conversion ratio is the number of shares of common which can be acquired by surrender of $100 principal amount of debentures or of a share of preferred stock for that type of convertible. Low ratios are equivalent to high prices for the common, and vice versa. It has been emphasized that the conversion ratio is the most important term. It can be so low that it will have no immediate value and the convertible will sell primarily on its value as a senior security. The ratio can range up to the point where the aggregate value of the common commanded at the current market is equal to the par value of the senior security and on up, so that the convertible's price is entirely dependent on the market price of the common. Where the conversion price is set will depend on the purpose or purposes to be achieved.

The convertible privilege may be made to change during the life of the issue and also be made to apply to only a part of the issue. For example, an issue of $16,677,100 convertible debentures was convertible at $60 principal amount of debentures for each share of common stock. The conversion price remained at that rate until $8,000,100 of the debentures had been converted;[15] then the rate changed to $66⅔ principal amount for each share of common. This feature tends to force conversion without any action on the part of the company. Thus, if the market price is above $60, and less than $8,000,100 has been converted, the holders will wish to be among the first $8,000,100 to convert rather than to be penalized by the higher conversion price. From the company's point of view, a possible danger arises if the step-up turns out to be too high and conversion is blocked.

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[15] This provision operated so that on the day that the amount converted reached $8,000,100, all the holders that sent in their bonds on that particular day prior to 3 P.M. received the same treatment, even though the total exceeded $8,000,100.

This change in the conversion price is what is known as a blackjack provision, so called because it holds a penalty over the holders' heads if they do not take action. If it is made to apply to only part of the debentures as above, investors may be in the dark in making their decisions as to whether or not to convert. It would be difficult for them to keep currently posted on the extent of conversion. This may result in some investor dissatisfaction.

In view of the whims of the stock market, a fancily designed convertible may look good on paper, but how it will work out certainly will be in the laps of the gods.

2. *The interest rate for debt, or preferred dividend rate for preferred.* This is discussed briefly in Chapter VIII, "Selling Common Stocks." There the primary point made has to do with price of the convertible in relation to the interest or dividend rate and the parity price of the common. As noted above, the type of investors who are to be attracted to the issue may determine whether the price is to be based on its value as a senior security rather than on common stock parity.

3. *The type of conversion feature by which the holder has to pay some cash as well as surrender the convertible issue in order to exercise the conversion privilege.* As an example, an issue may be convertible into one share of common stock for each of $100 principal amount of debentures upon the payment of $50 in cash. Thus, as conversion takes place, the company is provided with additional funds. Such a feature may be best suited to a holding company with many subsidiaries which have a continuing large demand for funds over a period of many years. This is an attractive feature as far as selling the issue is concerned, in that less money has to be paid by the investor for the convertible when it is sold.

4. *The call feature.* It provides the means by which the company can force conversion, provided, of course, the conversion value of the issue is above the call price. The call premium is generally low. That does not work any hardship on investors because they can convert, and it places the company in a favorable position if it wishes to force conversion.

The call privilege may be delayed. Investors will thus have some time during which they can voluntarily convert before the company can force conversion. This may fit in with a blackjack provision. The call provision must include a notice period, but the conversion right may be suspended ten days prior to the date fixed for redemption. Thus, if the company decides to force conversion by issuing a call, it will know ten days before the final redemption date how much will have been converted, rather than being faced with continuing conversions right up to the redemption date, leaving to be determined at the last minute the amount that will have to be paid off.

5. *Characteristically, convertibles do not carry a sinking fund.* Nevertheless, it does appear, under some circumstances, particularly with a weak issue, that a sinking fund may be justified, at least after the conversion period expires. For example, a regulatory authority suggested that for a company under its jurisdiction, a sinking fund should be included in a convertible, starting after the date that the conversion privilege expired, which was about ten years prior to maturity. The sinking fund was made equivalent to the savings resulting from the difference between the dividend requirements on the common stock and the interest payable on the debentures.

6. *There may be a delay in the start of the conversion privilege.* Preventing an immediate conversion postpones dilution in earnings per share and possibly exerts a stabilizing effect on the price of the stock during such period.

The conversion privilege may be made to expire before maturity. One of the reasons for shortening the period is to encourage conversion at an early date. Such action might be justified on this basis, but again it assumes that the market price of the stock will, without fail, be sufficient to make conversion attractive. If this is not the case, then the primary objective is defeated and the longer conversion period would be better.

### *Convertible Debentures or Convertible Preferred?*

We have gone through all the discussion without saying whether you should use a convertible debenture or a convertible preferred. The convertible debenture has the obvious advantage that the interest rate would undoubtedly be lower than the dividend on a preferred, and interest results in income tax savings.

A company's capital structure and its future financing plans will be the major determinant as to which is used. If a company has too much debt already and no preferred stock, a convertible preferred may be the better. On the other hand, if its debt picture is satisfactory, a convertible debenture will offer the advantages already mentioned. The other principal determinant in deciding whether to offer a convertible debenture or convertible preferred is the market receptivity. This will depend on the market at the time and the circumstances surrounding the company.

If a company's capital structure is overburdened with senior issues, it may be necessary to resort to junior convertibles in the form of second convertible debentures, or second convertible preferreds. While necessity may demand that type of security, it would be hoped that a company's policy would be so managed that everything possible would be done to avoid such a step.

### *How Convertibles Are Offered*

If the common stockholders have preemptive rights in respect of new issues of common, this privilege will generally extend to securities convertible into common stock. Otherwise, the company must make the choice whether to offer directly or through rights. In that decision, the same principles apply as for straight common stock, as discussed in Chapter VIII, "Selling Common Stock."

## WARRANTS

Warrants are included at this point because, when they are attached to another security, they give the latter some of the characteristics of a convertible. A convertible gives the holder the right to receive common through the exchange of the convertible security for common; a warrant entitles the holder to purchase common at a specified price. The term "warrant" is also used for the piece of paper evidencing a right of a stockholder to subscribe to a new issue when stock is offered to existing stockholders through rights. That type of warrant is similar in nature, but its life is limited to the relatively short subscription period.

A newspaper financial columnist, in reply to a question by an investor about stock warrants, explained them from the investor's point of view this way:

> Warrants—A Stock Option with a "Kick" [16]
>
> Stock warrants are options to buy common stocks at a fixed price sometime in the future. Some options are good for a few months or a few years; some are perpetual. When you buy a stock option, you are betting on the stock rising. Instead of buying the stock directly, you can participate in the advance by buying the warrant, which generally sells for a smaller sum.
>
> However, you should be warned that warrants receive no dividends and generally are extremely volatile. They can move fast in either direction. And if you buy one which expires you can lose all your money on that day if the stock has not risen to a price where exercise of the option is profitable.

Warrants may originate by being attached to a new issue of senior securities. The warrants may be permanently attached to the senior security, so that when it is subsequently sold by an investor the warrants go along with it, or they may become detachable so that the two securities can be sold separately. They may have a short or long life. The price at which they can be exercised may be made to change at a specified date. When warrants are exercised, of course, they go out of existence.

---

[16] Sam Shulsky, Assistant Financial Editor, *New York Journal-American*, November 3, 1959.

The purpose of warrants may be:

1. *To add a feature to induce an investor to buy the senior security which by itself would be difficult or impossible to sell.* The warrants impart an appeal which gives the purchaser an opportunity for a speculative gain if the company is successful and the market price of the common stock increases. In this situation the use of a stock warrant is a matter of necessity. Furthermore, it may be appropriate to give the senior security holder an opportunity to benefit if a risky venture proves profitable.
2. *To sweeten up an issue so that a lower interest or preferred dividend rate may be obtained on a senior security.* This use of a warrant is quite debatable and is discussed below.

If a warrant is used for the second purpose outlined above, a company is speculating on the proposition that the savings in interest or preferred dividends will be more than the additional price it could receive in the future from the sale of common over the price at which the warrant could be exercised. The following figures will illustrate the point:

1. A company sells $1,000,000 of debentures, with warrants attached. The maturity of the debentures is 20 years. There is no sinking fund.
2. The common stock is selling for $90 per share. The warrants are exercisable at $100 per share.
3. With each $1,000 of debentures, there are included warrants permitting the purchase of five shares of common.
4. As a result of the warrants, the interest rate on the debentures is 5½%, whereas without the warrants it would have been 6%. This will result in an annual interest savings of $5,000 per year, or a total of $100,000 in 20 years. Assuming an income tax rate of 50%, this would mean a $50,000 net savings.

Now let's assume that the common stock subsequently appreciates to $135 per share, and the warrant holders exercise their right to obtain common at $100 per share. This would mean 5,000 shares at $100 per share or a total of $500,000. If the company had not issued warrants, but had sold 5,000 shares of common at a net price per share, after all financing costs, of $120, it would have received $600,000. This is $100,000 more than the company got from the exercise of the warrants. And it compares with the $50,000 net savings in interest over the life of issue. On the basis of these figures, the company lost $50,000. For complete accuracy, the above calculations should be based on the present value of money, but the figures do illustrate the point.

To put the idea another way, for the company to gain by the use of a warrant, when there is no need to use one, the investor in the senior security must lose by guessing wrong on the advantage of accepting a lower interest or preferred dividend rate in the hope of more gain through the exercise of the warrant.

Once the warrant is issued, the company loses control of when it will get more common stock money, since it is the holder who has the option. Another disadvantage of a warrant is that it may be exercised at a time when the company has no need for cash. Furthermore, it represents a potential dilution of earnings per share of common stock from the added number of shares when it is exercised. This may have a depressing effect on the market for the common stock at a time when such an effect would be disadvantageous.

If it considers the use of warrants, a company should make a careful analysis of all the possible ramifications as was suggested in the case of convertible securities.

## COMMON STOCK

There can be classes of common stocks, similar to the situation for preferred stocks, with various shadings in voting privilege and preference as to earnings and rights to assets in liquidation. However, as has been said many times before, such complication should be avoided unless required by necessity.

The basis on which to decide the best terms for common stock is different from that for senior securities, since the stockholders own the company. The primary test should be what is good for them over the long run. The problem can be viewed with these two premises in mind:

1. There should be fair distribution of powers among the stockholders themselves, on the basis of number of shares. The desires of the holders of the majority of the stock should be most influential, but the minority stockholders should be protected against abuses.
2. The stockholders' position should be protected against unsound and unresponsive management.

Under no circumstances should any provisions be included which will protect the management against the stockholders, except those stockholders who try to interfere with the operations of the company to the detriment of the other holders. Unfortunately, in some instances, managements appear to become detached from the reality of their job of working for the stockholders. Provisions which will allow such an attitude are, of course, unsound.

The powers of the corporation derive from the consent of the stockholders. However, many of the major factors affecting the common stockholders are a matter of financial policy, such as debt ratio, dividend policy, stock splits, listing *vs.* non-listing, keeping the stockholders fully informed, setting proper profit goals, etc. They cannot be covered in the common stock provisions. Furthermore, the provisions of the senior securities will have an important bearing on the position of the common stockholders, although their effect may not become significant until financial difficulties are encountered.

The specific provisions directly pertaining to the common stock may be found in the charter, the by-laws, the stock certificate, resolutions of the board of directors and the laws of the state in which the company is incorporated. If the company is regulated, government authorities may require certain standards, as may the stock exchanges for listed stocks.

We will mention only a few ideas about provisions for the common.

### *Par or No Par*

Perhaps the first idea that might arise in your mind is whether common stock should be par or no par. The New York State transfer tax paid by the person who sells stock formerly was a factor affecting whether a stock should be no par or par, and the size of the par value. However, in January, 1959, the law was changed so that the tax is based on the value of the stock. How it is stated on the company's books has no effect.

Some state laws and regulatory authorities may require some companies to have a par value. And some states may impose a tax on the company based on the way the stock is carried on the books. Aside from these factors, par or no par is not a major consideration.

When new stock is sold which has a par value, it generally cannot be sold below par by state law. Therefore, if a company's stock has a par value, it should be low enough so that it will not hinder financing even under adverse circumstances. When you split your stock, you don't have to be worried about the reduction in the par value. If, after the split, it comes out to dollars and a fraction you may wish to transfer enough surplus to make it an even dollar, just for balance sheet appearances.

### *Pre-emptive Rights*

Some companies are required by the law of the state of incorporation to issue common stock and securities convertible into common to their stockholders through pre-emptive rights. Some companies, not so required by law, may have such a provision in their charter. Others are free from either restriction, and management can make a choice. The other method of offering such securities is by direct sale to the public.

In Chapter VII, the question of offering stock through rights or by direct sale is fully discussed. How to analyze correctly which is better for your stockholders is explained. All surrounding circumstances will determine which is better, but such an analysis may show that in most instances the rights method is preferable. Nevertheless, as far as charter provisions are concerned, it might be better for a large, publicly-owned company to have flexibility, so that it can follow whichever course seems more appropriate at the time. If a company is free to make a choice, the management should be responsive to stockholder interest in making such a decision.

### *Charter Changes*

Statutes of the state of incorporation will establish the minimum standards for the vote required for charter and certain other changes. In any large corporation with a widespread stockholder list there is a maximum vote that can be obtained which is hard to exceed on any proposal, no matter how important and uncontested. This is due to the fact that some companies have a certain percentage of stockholders who just don't vote. The size will depend on the nature of the stockholder list, etc. A vote of around 80% of the number of shares is high even under favorable circumstances. Therefore, a company may not wish to make the standards higher than the minimum required by statute.

### *Directors*

Since the directors represent the stockholders, the makeup of the board of directors is most important. There is much controversy over the method of electing directors, which revolves around non-cumulative or cumulative voting. Cumulative voting is required by the law in some states for companies incorporated therein; it is permissible in some and not allowed in others. The difference between non-cumulative and cumulative voting can best be explained by a simple example. Assume that three directors are to be elected, and a stockholder has 100 shares of stock. If the voting is non-cumulative, he can cast his 100 shares for each of three directors, or just one or two as he sees fit, but in no event will his vote count in favor of one director for more than 100 shares. In cumulative voting, each stockholder gets the number of votes equivalent to his number of shares multiplied by the number of directors to be elected. He can divide these votes between directors as he wishes. In other words, in cumulative voting, when three directors are to be elected, he can split up his 300 votes among the directors, or he can cast them all for one director. Minority stockholders, by concentrating their votes on one or a few directors, may get representation on the board.

The effectiveness of cumulative voting is dulled by staggering the terms of directors so that only a few are elected at a time. For example, if there is an eleven-man board and all eleven are elected at the same time, a holder of 10% of the stock would have slightly more than enough votes to elect a director. It works this way. Assume that there are 100,000 shares outstanding, and that a minority stockholder owns 10,000 shares. He would have 110,000 votes; the other stockholders would have 990,000 votes. If they spread their votes in an effort to try to elect the entire board, that would mean 90,000 votes apiece. The minority stockholder could easily elect one director. If there were a staggered election, the effectiveness of the minority stockholder would be progressively diluted as the number of directors elected at one time became less. If only one director were elected, cumulative voting would have no effect.

Cumulative voting is a hot issue between some managements and stockholder groups. It is contended by some managements that cumulative voting makes possible raids on companies by outside elements trying to obtain a voice in the management for their own benefit and to the detriment of the holders of the majority of the stock. On the other hand, small stockholder groups contend that without cumulative voting they are totally ineffective in obtaining any representation on the board. Enough has been written on this subject, both pro and con, that if one wishes to make a study of the matter, there is ample literature available.

Most important to stockholders of a publicly-owned company is the proper makeup of the board of directors so that the board will be effective in directing policies which will benefit the stockholders. What makes a good board will depend on the nature of the company. A long chapter could be written on this subject alone. Some of the obvious points are:

1. The management of the company should be free from pressure by directors which will in any way restrict the officers from making contracts, etc., on the best available basis. This applies in all matters.
2. Nepotism may deaden the spirit of an organization. When a family-owned company becomes publicly-owned, this should be guarded against. And for a company which is all publicly-owned, there is an obligation to avoid any such possibility.
3. A director should make a major contribution to a company, in one way or another, and should not continue to be on the board just for his satisfaction or benefit when he ceases to do so.

To obtain a knowledgeable, active, ideal board of directors as measured by all possible tests is not an easy matter. There may be exceptions where there is value in having some directors on the board even though they may have personal axes to grind. Therefore, one of the most important tests is those men's standards of business ethics. A director holds a position of highest trust, and his every action should be performed as if all the stockholders were looking over his shoulder.

A good board of directors cannot be assured by a company's charter or resolutions, but some provisions may be of assistance. The provisions of some companies governing the boards of directors are rather ancient, and revision may be needed. As a way of concluding this brief discussion of an important subject, there is set forth below a resolution by a board of directors of one company,[17] attempting to assure an active board.

WHEREAS, the members of this Board recognize that the quasi-public nature of the company's business and the widespread distribution of its securities among investors indicate the desirability of attendance, if possible, at Board meetings of all its members; they believe that Board members still active in their primary occupation will be in the best position to bring to the Board the benefits of their knowledge and experience in their particular fields; they believe also that Board members, after retirement from their principal business connection, may tend to be away from the northern Illinois area for extended periods or may, in fact, remove their residence from such area and thus may cease to represent the part of the area or activity which may have played a part in their selection as candidates for Board membership; they recognize also that disability or other circumstances may from time to time prevent Board members from active participation in Company affairs and thorough consideration of Company problems, in which event they understand that they should not expect to be nominated for re-election; they recognize further that, except in the case of advancing age, such events cannot be foreseen, but feel the wisdom of stating these principles and providing a definite policy for the retirement of Directors under the foregoing circumstances.

Now, therefore, BE IT RESOLVED: That it is the sense of the Board that no person should be designated by the Board as a candidate for election or re-election as a Director of the Company at the annual meeting of stockholders in the third calendar year following the calendar year of his retirement from his major or primary occupation, or in the calendar year in which he attains age 70, whichever first occurs; provided, however, that any Director now serving on the Board who would otherwise be required to retire under the provisions of this resolution may nevertheless be designated as a candidate for re-election at the annual meeting of stockholders in each of the years 1957 and 1958.

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[17] Northern Illinois Gas Company.

These same general ideas about having an active board apply to most publicly-owned corporations. They are badly needed for some companies, and much thought should be given to the whole subject. It is not a direct part of financial policy, so we won't dwell on the subject any longer; but since financial policies are passed on by the directors, there is actually a close relationship. Furthermore, directors have a major responsibility in preserving our system of private capital by establishing sound and fair policies. Anyone who takes on this responsibility for a publicly-owned company should study thoroughly not only the legal aspects, but also the scope of the position, and the ethical standards required. A board member who allows himself to be a rubber stamp for the management's policies lacks sufficient character for the position. Such a person obviously fails in his duty to represent the stockholders. To do a good job as a director, a person must understand many phases of business and keep up on the dynamic changes which are ever taking place in our fast-growing society.

*CHAPTER VI*

# The Financial Community: Who Does What

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As stated in the book's introduction, there seems to be a cloak of mystery surrounding Wall Street and finance, and a feeling that financial organizations are something quite apart from everyday life—perhaps because they deal in money. As you get to know who does what, much of the mystery disappears. You see that many of the organizations find their counterpart in other types of business where the middleman trades in a commodity; in finance the commodity just happens to be securities and money. The same forces work as in other businesses: the law of supply and demand, the incentive to make a dollar, and regulation largely through competition.

There are, of course, some organizations connected with the money market which are special in their nature. The Federal Reserve System is one. It can assist in adding to or subtracting from the supply of money as one of its functions. But even for such organizations, the principles governing their operations are not too difficult to understand.

Besides giving information about the financial community in order to reduce the mystery, there are some practical reasons for this chapter. It will help you better understand the type of firms that deal in your company's securities, affect their prices, and perform many other functions. You will be rubbing elbows and transacting business with them in raising capital and keeping investors informed. That is the reason this chapter precedes the next two on selling securities.

For example, the chapter will help answer such questions as: How does an underwriting organization, which handles the sale of new securities, work? What are the general classes of security buyers, and how may their legal and economic limitations determine whether they will buy your securities? What is the difference between a broker and dealer? What are the different markets for outstanding securities? If your company's stock is listed on an exchange, how may the quotation be different from those of unlisted companies? Whether or not your company should be listed requires a knowledge of the different security markets; in fact, you cannot work with finance unless you thoroughly understand what is back of the price of your "commodity."

Some of these subjects have been written about time and time again. However, we will try to highlight the information as it ties in with the job of the Financial Vice President.

## BROKER AND DEALER

Let's start off with the broker and dealer, and the way they handle purchases and sales of outstanding securities. What adds to the confusion here is the fact that one firm may act in both capacities, at one time as a broker and at another as a dealer, and, in fact, it may also do business as an underwriter. A firm may be loosely referred to as a broker, a dealer or an underwriter, and do all three types of business. On the other hand, one firm may specialize in a single one of these functions.

The distinction between a broker and dealer is as follows:

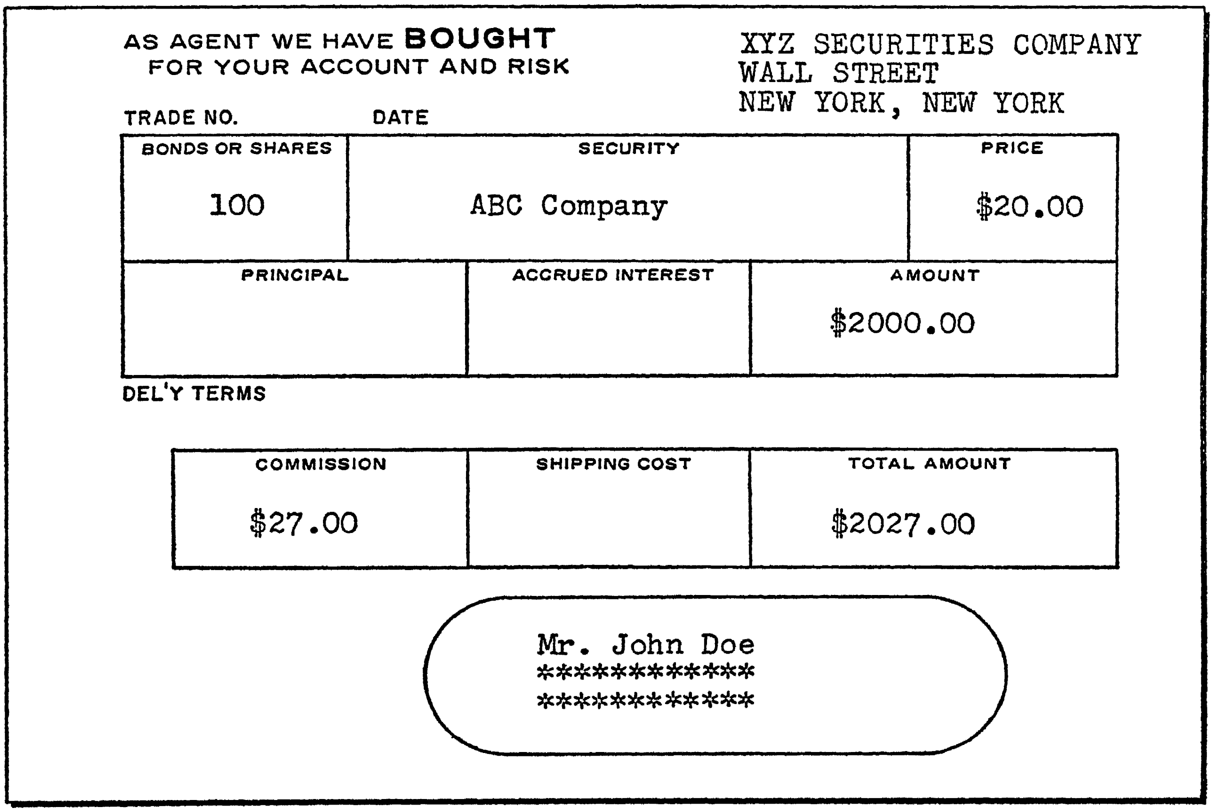
> A *broker* is an agent. The legal definition of an agent, in simple terms, is—one who acts under the instructions of a principal to buy or sell a security; an agent never takes title. The broker is a middleman. He receives a commission.
>
> A *dealer* acts as a principal and generally has title to a security before he sells it to you, and he takes title if he buys it from you. His compensation is measured by the spread between the price at which he buys and sells. This spread is in lieu of the commission which the broker receives.

The broker has no securities or merchandise on his "shelves" to sell you. When he receives an order, he contacts someone who owns the security through the facilities of a stock exchange and buys for you, not for himself. This is accomplished by the broker going to the proper "post" on the floor of the exchange through his representative there and engaging in bidding in that auction market as your agent. The dealer, on the other hand, usually has merchandise on his "shelves" which he owns and which he sells to you. If he has none he will buy some, take title and then sell them to you at an increased price.

When you bought some stock for your personal account, you probably did not notice whether the firm acted as broker or dealer. If you looked on the slip of paper you received confirming the transaction, the difference would become apparent. These are examples of what you would see:

The first slip evidences a broker transaction. It includes the word "agent" in the upper left hand corner and the amount of the commission in the lower left-hand column.

The second one uses the word "principal"



AS AGENT WE HAVE **BOUGHT**
FOR YOUR ACCOUNT AND RISK

XYZ SECURITIES COMPANY
WALL STREET
NEW YORK, NEW YORK

TRADE NO. DATE

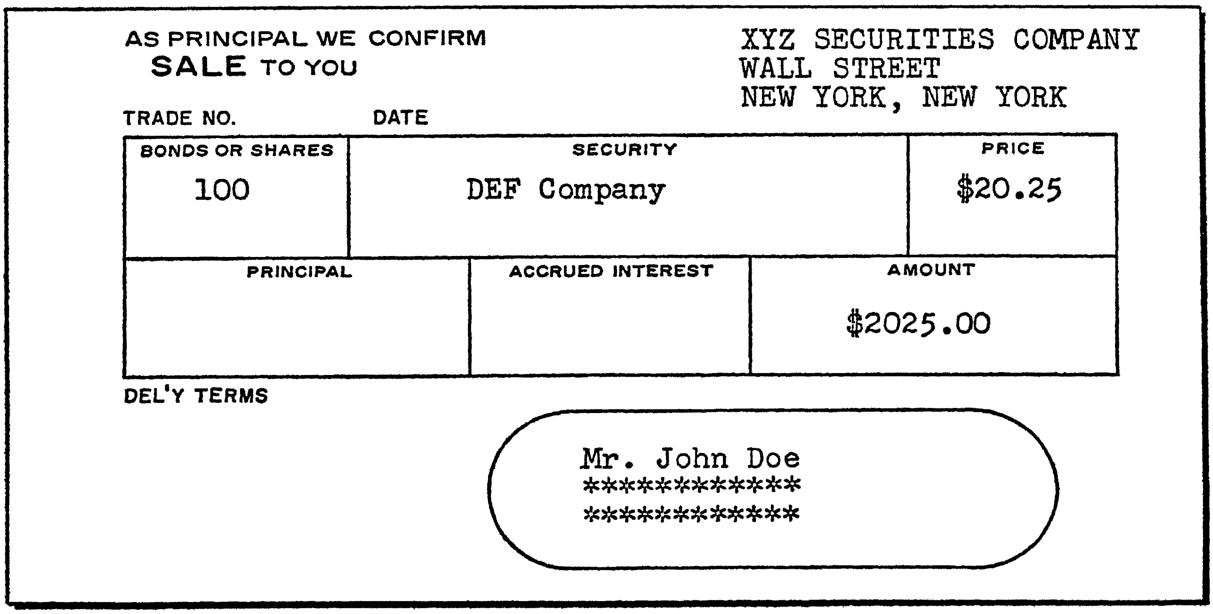
| BONDS OR SHARES | SECURITY | PRICE |
|---|---|---|
| 100 | ABC Company | $20.00 |

| PRINCIPAL | ACCRUED INTEREST | AMOUNT |
|---|---|---|
| | | $2000.00 |

DEL'Y TERMS

| COMMISSION | SHIPPING COST | TOTAL AMOUNT |
|---|---|---|
| $27.00 | | $2027.00 |

Mr. John Doe
************
************



AS PRINCIPAL WE CONFIRM
**SALE** TO YOU

XYZ SECURITIES COMPANY
WALL STREET
NEW YORK, NEW YORK

TRADE NO. DATE

| BONDS OR SHARES | SECURITY | PRICE |
|---|---|---|
| 100 | DEF Company | $20.25 |

| PRINCIPAL | ACCRUED INTEREST | AMOUNT |
|---|---|---|
| | | $2025.00 |

DEL'Y TERMS

Mr. John Doe
************
************

and is a dealer transaction. There is no commission. It gives the price the buyer was charged, but not what the dealer paid nor how much he made.

The $27 the broker made is the commission for such a transaction for a stock listed on the New York Stock Exchange. For illustrative purposes, the amount the dealer received is almost the same, but stock quotes are made in ⅛'s, ¼'s, ½'s, etc.; so if we made them exactly the same, our figures would be wrong.

In reading what follows on the broker and the dealer, you should pay attention to the size of the compensation. After all, brokers and dealers have to make a living too, and it is the compensation they get which keeps them interested in your securities. For example, it is the difference in compensation of a dealer transaction as compared to a brokerage transaction that has a lot to do with the question of listing or not listing on an exchange. And you should be interested in the compensation because it is your security holders who have to pay it.

Securities which are listed on an exchange must be handled on a brokerage basis by firms which are members of the exchange. The minimum commission rates are generally established by the exchange. Securities which are not listed are mostly handled on a dealer basis. There are exceptions. It is possible to purchase or sell an unlisted security on a commission or agency basis. Firms which are not members of an exchange may handle listed securities on a dealer basis. You don't need to be concerned with the exceptions.

Let's see how markets are made by brokers and dealers. As we have already noted, there are two different markets for outstanding securities:

The market for listed securities which are handled on the "floor" of one or more of the exchanges.

The market for unlisted or over-the-counter securities. These are traded "over-the-counter" as contrasted with the "floor" of an exchange. In the over-the-counter market, there is a retail and a wholesale market.

We will first distinguish between the retail and the wholesale market for over-the-counter securities.

## THE MARKET FOR OVER-THE-COUNTER SECURITIES

### *The Retail Market*

In the financial newspapers, and some of the large metropolitan newspapers,[1] you will find an over-the-counter section giving the retail market. Many times more issues are traded over-the-counter as on all the stock exchanges combined. Over-the-counter trading is done on a negotiated rather than on an auction basis. You will note that there are no sale prices, but bid and asked quotations. In the New York edition of *The Wall Street Journal,* in the section for over-the-counter markets, there is a sub-group for National Market quotations for industrial and utility stocks. An example of the first three stocks quoted appears above.

| | *Bid* | *Asked* | *Previous Bid* | *Spread* | *Spread as % of Bid* |
|---|---|---|---|---|---|
| Aerovox Corp. | 14½ | 15¾ | 14⅜ | 1¼ | 8.6% |
| Air Products | 44¼ | 47¼ | 45¼ | 3 | 6.8 |
| Am. Biltrite Rub. | 25 | 27 | 25 | 2 | 8.0 |

These quotations are furnished to the newspapers by the National Association of Securities Dealers. The bid and asked quotations do not represent actual transactions but are a guide to the range of prices within which the public could have expected to buy and sell the securities at the time of compilation. It is beneficial for an unlisted company to have its stock included in the over-the-counter columns of the newspapers because it gets the company's name before investors. Furthermore, having the quotations readily available is a service to investors. The securities quoted are limited to those in which there is the greatest national interest. If a company thinks it should be included, it should apply to the National Association of Securities Dealers committee.[2]

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[1] The National Association of Securities Dealers estimates that 150 newspapers carry quotations on some over-the-counter securities regularly. There is a difference among the papers as to which securities are quoted. It is estimated that quotations on over 2,500 securities appear in some papers.

These are the prices at which a dealer will buy securities from you as an individual investor: the bid prices and the prices at which he will sell securities to you: the asked prices. These are retail quotations. Note the size of the spread between the bid and asked. It was 8.6%, 6.8%, and 8.0% of the bid price, respectively, for the three stocks, and it may be even greater.

### *The Wholesale Market*

Some dealer firms are wholesalers. They trade only with other dealers and large institutions—just like wholesale merchants, as contrasted with retail stores. The many small retail security dealers throughout the country may get their merchandise from the wholesale dealers. Some dealers are both wholesalers and retailers. In the wholesale market the spread between the bid and asked is smaller because, among other reasons, the number of shares traded in a transaction is generally larger and there is vigorous competition. The wholesale market is referred to as the inside market. You, as an individual security buyer, never see the wholesale prices, but there is a written quotation system for the wholesale dealer fraternity. It is known as the "Pink Sheets."

The "Pink Sheets" are a product of a unique firm, The National Quotation Bureau, Inc., tucked away in a five-story building a few blocks south of Wall Street—46-52 Front Street—an essential cog in the over-the-counter security market, where a beehive of activity exists about 3 o'clock in the afternoon on each business day.

Here is what the Bureau does. Each dealer who is interested in making a wholesale market in certain securities will fill out separate slips of paper for each security, showing the name of his firm and the price at which he would be willing to buy or sell. Every day around noon a messenger from 46 Front Street starts picking up these slips. They are rapidly sorted by name of the security. By a mimeograph process this information is compiled in the so-called "Pink Sheets." It lists all the principal over-the-counter securities with the dealers' names and their quotations. The "Pink Sheets" are rushed to the airport for airmail delivery out-of-town. They are delivered by hand in New York early the next morning.

The dealers keep close contact with one another by direct wires or by the regular telephone system. They are continuously checking quotations with each other, either in carrying out a transaction, or in order to keep abreast of the market. As the day goes on, the quotations for a security may be higher or lower than shown in the most recent "Pink Sheets," depending on all the factors that make the price of a security change. But the "Pink Sheets" do give the necessary background to facilitate trading in over-the-counter securities. In fact, if the National Quotation Bureau, which is mostly owned and run by Lou Walker, did not exist, a similar service would have to be formed because it fulfills such a necessary function.

The wholesale quotation in the "Pink Sheets" for the three stocks for which the retail market was given was as follows for the same day:[3]

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[2] To obtain information regarding an application, a letter can be addressed to the Executive Director, National Association of Securities Dealers, 1707 H Street, NW, Washington 6, D.C.

[3] The numbers next to the names are the teletype code numbers. The figure 50 next to the price for Air Products is the number of shares that the dealer is interested in buying at that price. OW and BW means orders wanted and bids wanted.

| | | | | | |
|---|---|---|---|---|---|
| *Aerovox Corp.* | May & Gannon Inc BOSBS 902 | CA6 2610 | | 14½ | 15 |
| | Janney Dulles & Battles Inc PH80 | WO6 5646 | | 14½ | 15 |
| | J B Maguire & Co Inc BOSBS 142 | CA6 1613 | | 14½ | 15 |
| | Eastman Dillon Un Secs & Co NY1-752 | BO9 3151 | | 14½ | 15 |
| | Greene & Co NY1-1126 | HA2 4850 | | 14⅜ | 14¾ |
| | Cruttenden Podesta & Co NY1-4663 | BO9 2700 | | 14⅜ | 14⅞ |
| | Troster Singer & Co NY1-376 | HA2 2400 | | 14½ | 15 |
| | Singer Bean & Mackie Inc NY1-1825 | HA2 9000 | | 14½ | 15 |
| | Gregory & Sons NY1-865 | WH3 7600 | | 14½ | 15 |
| | G A Saxton & Co Inc NY1-1605 | WH4 4970 | | 14⅜ | 14⅞ |
| | Eastern Securities Inc NY1-4127 | DI9 3552 | | 14½ | 15 |
| | New York Hanseatic Corp NY1-40 | WO4 2300 | | 14½ | 15 |
| *Air Products* | New York Hanseatic Corp NY1-40 | WO4 2300 | | 44 | 45 |
| | May & Gannon Inc BOSBS 902 | CA6 2610 | | 44¼ | 45 |
| | Troster Singer & Co NY1-376 | HA2 2400 | | 44 | 45 |
| | Alfred L Powell & Co Inc. NY1-3244 | WH3 8250 | | 44 | 44¾ |
| | Shields & Co NY1-1680 | WH3 5460 | | 44 | 44¾ |
| | Arthur Wiesenberger & Co NY1-420 | WH3 8992 | 50 | 44 | |
| | J C Bradford & Co NY1-2253 | WH3 7262 | | 44¼ | 45 |
| | Reynolds & Co NY1-635 | WO4 6700 | | 44¼ | 45 |
| | Ernst & Co NY1-1137 | CO7 5600 | | 44¼ | 45¼ |
| | Granbery Marache & Co NY1-1765 | BO9 4700 | | 44¼ | 45 |
| | Kidder Peabody & Co NY1-3893 | HA2 8900 | | 44½ | 45½ |
| | Fitzgerald & Co NY1-2073 | WH3 9060 | | 44¼ | 45 |
| | P F Fox & Co Inc NY1-944 | RE2 7760 | | 44 | 44¾ |
| | Kuhn Loeb & Co NY1-2507 | HA2 9200 | | OW | BW |
| | Peter P McDermott & Co NY1-1817 | DI4 7127 | | | |
| | Blyth & Co Inc NY1-327 | RE2 1900 | | | |
| *Am. Biltrite Rub.* | Eastman Dillon Un Secs & Co NY1-752 | BO9 3151 | | 25¼ | 26 |
| | New York Hanseatic Corp BOSBS 208 | LA3 3300 | | 25¼ | 26 |
| | Eastern Securities Inc NY1-4127 | DI9 3552 | | 25½ | 26¼ |
| | Carr & Thompson Inc BOSBS 328 | WH3 7600 | | 25¼ | 26 |
| | May & Gannon Inc BOSBS 902 | CA6 2610 | | 25¼ | 26 |
| | Gregary & Sons NY1-865 | WH3 7600 | | 25½ | 26¼ |
| | A C Allyn & Co Inc NY1-757 | DI4 0909 | | 25¼ | 26 |
| | Singer Bean & Mackie Inc NY1-1825 | HA2 9000 | | 25½ | 26¼ |
| | Smith Barney & Co Inc NY 128 | DI4 5911 | | 25¼ | 26 |
| | Du Pont Homsey & Co BOSBS 424 | CA6 8100 | | 25¼ | 26 |
| | Goldman Sachs & Co NY1-165 | WH4 2300 | | 25 | 25¾ |
| | G C Haas & Co NY1-2746 | BO9 7060 | | 25½ | 26¼ |
| | Cruttenden Podesta & Co NY1-4563 | BO9 2700 | | 25½ | 26¼ |
| | J B Maguire & Co Inc BOSBS 142 | CA6 1613 | | 25¼ | 26 |
| | Swift Henke & Co CG900 | FI6 2800 | | OW | BW |

Note the difference in spread between bid and asked—about 3.4%, 1.7%, and 3.0% respectively for the three stocks, expressed as a percentage of the bid price. This compares with the retail spread for the same stocks, as previously noted, of 8.6%, 6.8%, and 8.0%. In other words, the spread in the retail market was about three times greater, on the average, than that in the wholesale market.

This service of the National Quotation Bureau is restricted to the dealers who are registered with the Securities and Exchange Commission and meet other requirements of the Bureau. A fee is paid for each of the quotations listed. Outsiders do not have direct access to it. However, it is well to know that a company may, for a small fee, obtain the wholesale quotations for its securities. Elaborate files have been maintained by the Bureau. The authenticity of these quotes has been recognized by courts. So if your company's stock is traded over-the-counter and you want the wholesale market price on a certain day, or ranges over the years, here is where you can get it.

There is more to the service than just the "Pink Sheets." They are the ones most often used because they cover stocks. But the many quotation sheets Lou Walker's staff carefully compiles are as follows:

*Daily*

1. Bond Section—Eastern (published in New York City),
   Western (published in Chicago),
   Pacific Coast (published in San Francisco).
2. Stock Section—Eastern (published in New York City),
   Western (published in Chicago),
   Pacific Coast (published in San Francisco).
3. U. S. Governments, Municipals, and Territorials.

*Monthly Summary*—Bonds, Stocks, Canadian Securities.

### *How Markets Are Made in Over-the-Counter Securities*

Making markets in securities requires skill. It must be done on an ethical basis, but an astute dealer must sense what the other fellow has in mind and reveal his own hand only when necessary; otherwise, his ability to trade is lost, and he would be merely acting as an order clerk, paying the other fellow's price. A dealer, making up his mind whether to be a buyer or a seller, will weigh such factors as: his existing or potential orders one way or the other; the condition of securities markets and all factors affecting the market of the particular security.

It works this way: A certain wholesale dealer has traded in *X* company's stock for many years. He knows the type of people who have bought it, where much of it is held, the other wholesale dealers who trade in it, the local retail dealers who might be interested in it, etc. He is thoroughly familiar with the outlook for the company. At present his inventory of the security has been sold out. Noting the interest which has been shown in the stock recently, he feels that it is somewhat underpriced. If he can purchase some at the right price, he anticipates that he can find a buyer and make a decent spread. He decides to purchase up to 500 shares. First, he glances at the quotes in the "Pink Sheets." The wholesale quotations are about 20½ bid and 21 asked. The general market for securities has been slightly weak today so he checks the market with the dealers he knows who trade in the security by calling each one: "How do you hear the market for *X* company?" Neither trader can reveal his hand, or he would lose his bargaining position; so our wholesale dealer does not say he wants to buy 500 shares. In fact, he does not even reveal whether he is a buyer or seller. Each one he calls holds to his previous quotation, and the market for the stock turns out to be thin with little stock being offered. He is afraid that if he tries to pick up 500 shares, he will push up the price.

Thus, not being satisfied with the indicated market in New York, he decides to call an out-of-town dealer, who has previously put away some of the stock with investors. The conversation goes like this:

> Dealer Wholesale to Dealer Retail: "What have you been doing with *X* company stock?"
>
> Dealer Retail: "I don't have any customers for more of the stock, but some of my customers who previously bought it might be interested in taking their profits. They have done well in it. If you would be interested, I might be able to dig up a few hundred shares for you. What is your interest?"
>
> Dealer Wholesale: "I might be able to place some of it at $20½."

At this stage Dealer Wholesale has had to tip his hand, but not to the extent of saying he wants 500 shares.

> Dealer Retail: "Give me a few hours to see what I can do."

Then Dealer Retail calls his customers and offers $20. He digs up 300 shares, and resells them at 20½, to Dealer Wholesale who is now interested in selling the stock, at a price of perhaps $21, to a second retail dealer, who in turn will resell it to a new investor at $21¾. In short, these are negotiated transactions whereas there is an auction market on the floor of a stock exchange. These transactions may be summarized in terms of bid and asked terminology as follows:

| | |
|---|---|
| 1st Dealer Retail—Bid $20 = 's price to customer selling | Asked 20½ |
| Dealer Wholesale—Bid $20½ | Asked 21 |
| 2nd Dealer Retail—Bid 21 | Asked 21¾ = 's, price to customer buying |

There are, of course, many variations in the way transactions arise, but it is in this manner that over-the-counter stocks, which some investors want to sell, move into dealers' hands and out again to other investors who want to buy. The price of a security becomes equated to the demand and supply through the constant contact of one dealer with another in vigorous competition, each watching factors which affect its value, and the demand and supply between themselves and the ultimate investors.

It might be noted here that all this trading is done over the phone. Many dealers have traded with each other all their lives but have never met face to face. Millions of dollars of securities are sold each day by word of mouth. There is no concurrent exchange of written records except the subsequent confirmation slip. And yet it is almost unheard of for a security dealer to welch on his word, even if it subsequently turns out that he has made an unwise commitment. If differences of opinion arise among traders concerning the exact amount of stock included in a given transaction, or as to the price, principals of the firms involved ordinarily reach an amicable agreement or settlement of the matter.

We have been talking about the part the dealers play in trading in securities which are already outstanding. Before we leave the dealers, it might be well to mention that they also play an important role in the distribution of new securities issues. They do part of the selling job and form what is known as the selling group. This we will see when we get to the chapters on selling new security issues.

## THE STOCK EXCHANGE MARKET

Now let's turn to the stock exchanges and see how prices for outstanding securities are arrived at there. The other element that makes up an exchange beside the securities is the members who own the seats. A seat is merely the term for a membership. The seat can be sold and there is a market for seats when any are available. In order to be permitted to buy a seat, you must have a certain amount of capital and be investigated for integrity, to mention one criterion.

The market for listed securities is made on the floor of the exchange. Only members are permitted to trade in securities on the floor. Members may operate as individuals or be affiliated with member organizations.

The responsibility for making markets in listed securities rests with those members who have been accepted as specialists. They are assigned stocks according to their ability to handle the trading task. In addition to acting as agent for other brokers, the specialist must to a reasonable degree buy or sell for his own account. In this respect, his function is somewhat like that of a dealer trading in unlisted securities.

The purpose of the exchange is to provide an orderly auction market for the purchase and sale of securities. By orderly market is meant two things—reasonably narrow spread between bid and asked prices and, in so far as possible, a smoothing out of erratic price fluctuations due to temporary imbalance of the demand and supply. A narrow spread between bid and asked is an obvious advantage to an investor.

It is the job of the floor specialist to carry out the purpose of the exchange. In order to do so, he may have to participate in the market by increasing his own holdings and provide a demand if there is a temporary flood of sell orders without corresponding buy orders; and vice versa, that is, if there is a temporary flood of buy orders with no sales, he will sell or go short stock and provide a supply.

He makes part of his income from the difference between the prices at which he buys and the prices at which he sells, depending on the condition of the market. He, of course, is in business to make money, and he can only assist in smoothing out the fluctuations in the purchases and sales of securities. If there is a continuous flood of sales, he cannot keep buying and holding up the price. He will have to keep lowering his bid price based on his estimate of the flood of selling as compared with purchases.

Another of his functions, as mentioned above, is to act as an agent for brokers, for which he is paid a commission.[1] In this capacity the floor specialist keeps a "book" on the number of shares and the prices at which there are offers to buy and sell the securities which have been assigned to him. Many orders are entered at the market, which means that the buyer or seller will accept the price prevailing at the time. An example of a book of a specialist on the New York Stock Exchange is as shown in the next column.[2]

The numbers opposite the prices are the number of shares in units of 100 with the names of the buying and selling broker. The orders to buy at 50½ have been executed by the specialist for the two buying brokers. The initials after the names indicate the selling brokers. The order to buy 100 at 50¼ has been canceled.

The orders must be executed by the floor specialist in accordance with well-defined rules of the exchange, in order to protect the position of each buyer and seller against any possible favoritism.

Transactions on the floor of the exchange may occur by an additional method. A broker may sell directly to another broker without the specialist participating in any way. However, when this is done, it must be done in the presence of the specialist, so that he knows what is going on in the stocks in which he specializes. Thus, all transactions by members of an exchange in a listed stock are concentrated at one focal point, that is, the specialist.

| BUY | | SELL (in red) | |
|---|---|---|---|
| 50 | 1 Loper<br>2 Gaw<br>1 Green | 50 | |
| 1/8 | | 1/8 | |
| 1/4 | 2 Evans<br>~~1 Brown~~ C | 1/4 | |
| 3/8 | | 3/8 | |
| 1/2 | ~~1 Kind CDE~~<br>~~1 Sail FGH~~ | 1/2 | |
| 5/8 | | 5/8 | 1 Ball<br>1 Lean |
| 3/4 | | 3/4 | 1 Moon<br>1 Pike |
| 5/8 | | 5/8 | |

You might not think that *The New Yorker* magazine would include an article about a specialist on the floor of a stock exchange. One of the most fascinating articles ever written on the operations of the specialist did appear in that magazine. It was entitled "David Jackson and the True Mobility"[4] and was about one of the specialists on the floor of the American Stock Exchange. Some of the stocks on the American Exchange, because of their nature, may have a wider fluctuation than those on the New York Stock Exchange and be more of a problem for the specialist to handle.

To give you a little change, and to present a more comprehensive view of how the specialist carries out his function of keeping an orderly market, let's glance at a few quotations from *The New Yorker* to see how that magazine told the story in its interesting style.

First, you may wonder what the title of the article signifies. The explanation is that "the specialist . . . keeps the stocks he specializes in readily marketable and orderly in their fluctuations, and . . . without him prices would tend to rise and fall too often and too fast, causing unnecessary losses to the public and making stock investment even riskier than it inherently is." In other words, the specialist "gives capital true mobility."

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[1] The commission the specialist earns when he acts as agent for a broker is paid by the broker and not by the broker's customers.

[2] Example from New York Stock Exchange booklet "Now, about the Specialist. . . ."

[4] By John Brooks, *The New Yorker,* Oct. 1, 1955, Volume 31.

The article goes on to tell what David Jackson did in leveling out price movements in certain instances.

Coastal Caribbean Oils, a speculative Florida drilling venture whose stock had never previously been traded, was admitted to trading on the American Stock Exchange on February 2, 1953, with Jackson as its specialist. No one had the slightest idea of the company's prospects or, in consequence, of what price its stock should sell at—5, 25, 75, anything. Before the opening bell that morning, Jackson found that brokers had put in orders to buy 77,000 shares "at the market," meaning at whatever price asked by the sellers. To fill these, he had orders to sell only 12,000 shares, at prices up to and including 5½. Jackson, following his usual custom when he encounters a glaring imbalance between the number of buyers and sellers, began trying to even things up; in this case, he got in touch with the brokers in an effort to whip up enthusiasm for selling Coastal Caribbean short. But the brokers—or, rather, their customers—were bullish on Coastal, and not interested in selling the stock short. Jackson shrugged his shoulders, said, in effect, "Well, if you won't sell it, I will," and filled his orders by going short 65,000 shares of Coastal Caribbean at 5½. He spent the next hour or so praying—with understandable fervor—that Coastal wouldn't report a gusher, since he was in a position to lose sixty-five thousand dollars each time the stock rose a single point. However, no gushers were reported, and after an opening flurry the stock began to plummet at a speed extremely satisfying to Jackson. Each time the asking price dropped an eighth of a point, he bought 10,000 shares to fill his commitment at 5½. By noon the next day, he was covered—he had bought all the 65,000 shares —and had a profit of about forty-five thousand dollars. He did not, as one might expect, knock off and take a month's vacation; his experience as a specialist had taught him that before long he was bound to find himself in a deal that would go the other way, and that he would need the Coastal Caribbean profit to cover his losses.

Jackson was quite right. Fifteen months later, he suffered the worst setback on a single deal that he has had in his whole career as a specialist. On April 21, 1954, Canada Southern Petroleum, one of his stocks, indulged in what is known as a spin-off—splitting itself up to form new companies, in this case, Canso Natural Gas and Canso Oil Producers. The first few trades after the spin-off reflected confidence in the trio resulting from this feat of economic fission, but in the weeks that followed, the stocks of the two new companies began to sink precipitously—Canso Natural Gas from 2⅞ to 1 and Canso Oil Producers from 11½ to 3. Canada Southern Petroleum, the parent company, held fairly firm at around 3. In an attempt to halt the decline of the infant stocks, Jackson repeatedly bought shares of both Cansos. At times, there were absolutely no bids from the public to buy Canso Oil Producers at any price, and Jackson, with grave misgivings, would grit his teeth and go on buying it himself. (His alternative would have been to ask the board of governors for permission to let the stock drop unchecked, but in Jackson's view this would have been like a football player's complaining to the coach about a Charley horse as soon as the game gets rough.) Within a month, Jackson found himself "eating" Canso stock—holding a great many shares of little value or promise and in no demand in which he had invested a large part of his capital. He finally got out of the mess at a loss of a hundred thousand dollars. Usually Jackson is too hardened to the vagaries of the market to be emotionally affected by them, but this time he was a trifle shaken. Feeling an intense desire to get away from the floor of the Exchange for a while, he counted up what he had left and, finding that he had enough to keep his business going, with three trans-Atlantic boat fares to spare, he announced to his wife and daughter that they were all going to Europe for a two-month vacation. And off they went.

The specialist is in a position to make money and make it easily if he did not also have a sincere interest in carrying out his economic function of maintaining a close market in which there is only a narrow gap between the highest price being bid for a stock and the lowest price at which it is offered. He may make money on part of his business, but he must be ready and able to lose on part. His ethical standards must be high. The exchanges watch carefully the operations of the specialist and will not tolerate poor performance, since the exchanges seek to provide a fair and orderly market place.

So if an investor, Smith, wants to sell a listed security through a firm which is a member of an exchange, here is the way he works: Smith calls his broker and instructs him to sell 100 shares at the market, which is bid 20, asked 20⅛. To execute the order the broker calls the firm's partner on the floor of the exchange, who goes over to the post where the stock is traded. From here on let's assume that the transaction is handled by the specialist in his role of providing a fair and orderly market. There are no buyers immediately available for the stock; so the specialist buys Smith's 100 shares at $20.00 per share. Smith gives his broker the 100 shares he wanted to sell and receives $2,000, less brokerage fees of $27.00.[5] He will also have to pay some transfer taxes, which are paid by the seller, not by the purchaser.

To make it simple, let's assume that shortly thereafter, with no change in the market price and no new sellers entering the market, Jones wants to buy 100 shares. To execute the order he calls his broker, who contacts his firm's partner on the floor. The floor partner goes over to the specialist who sells the 100 shares he bought from Smith to Jones at $20.125 per share, or a total of $2,012.50. Jones pays his broker fees of $27.13. The specialist gets the $0.125 per share difference between the price at which he bought the stock and that at which he sold it, or a total of $12.50. This is a representative spread for large active stocks on the New York Stock Exchange. Thus one broker made $27.00 and the other $27.13. The specialist made $12.50, less transfer taxes which must be paid by the specialist, since this is a separate transaction from the original sale by Smith.

It looks as though the specialist member got something for doing very little work. As it appears in this transaction, he did, but remember that the specialist did assume the risk of an adverse development in the market when he bought and held on to Smith's stock until Jones came along and bought it.

## SUMMARY OF MARKETS

Up to now we have primarily examined what the security markets are and how they are made. Now we will summarize what has already been said with emphasis on how much the broker and dealer make. Their profit is their incentive for acting in their respective capacities. We will use the same figures for a 100-share trade as above.

In our stock exchange example, the floor specialist made 0.6%, and each broker approximately 1.4%. If one broker had a customer who wanted to buy a security and another who wanted to sell, he would make a commission both ways, or 2.8%. There was a total difference of 3.4% between the net proceeds the seller of the security got and the cost to the buyer of the same security.

Contrast this with figures for the over-the-counter market. An analysis of the industrial and utility stocks in the eastern market priced

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[5] The brokerage commission, which is paid by a seller of stock as well as a buyer, varies with the number of shares and price per share. Examples of the minimum commissions, which are about the same on all exchanges, are as follows:

| | | *50 shares* | | | *100 shares* | |
|---|---|---|---|---|---|---|
| *Price of stock per share* | *Total Value* | *Commission Amount* | *Commission % of Value* | *Total Value* | *Commission Amount* | *Commission % of Value* |
| $20 | $1,000 | $15.00 | 1.50% | $2,000 | $27.00 | 1.35% |
| 25 | 1,250 | 17.50 | 1.40 | 2,500 | 31.50 | 1.26 |
| 50 | 2,500 | 29.50 | 1.18 | 5,000 | 44.00 | 0.88 |
| 75 | 3,750 | 35.75 | 0.95 | 7,500 | 46.50 | 0.62 |
| 100 | 5,000 | 42.00 | 0.84 | 10,000 | 49.00 | 0.49 |
| 125 | 6,250 | 43.25 | 0.69 | 12,500 | 51.50 | 0.41 |
| 150 | 7,500 | 44.50 | 0.59 | 15,000 | 54.00 | 0.36 |

In figuring total cost to buy an odd lot, when the round lot is figured in 100 share units, add ⅛ to the round lot market price when it is under $40, add ¼ when it is $40 and over. When an odd lot is sold, the ⅛ and ¼ are deducted.

at $10 or more,[6] as quoted in *The Wall Street Journal* on one day, showed an average spread of 8.7% between the retail bid and asked prices. If a retail dealer bought from one investor and sold to another without going to a wholesale dealer, he would make the full 8.7%. There was an average spread of approximately 3.5% on the same day between the wholesale bid and the asked price for the same stocks.

There is a limit to what is considered a reasonable spread for an unlisted security. The National Association of Securities Dealers sets the policy and polices the dealers. A maximum figure for a reasonably active stock is 5%[7] between the price at which a retail dealer buys a security from a wholesale dealer and the price for which he sells it to a customer. It is generally less, but may be larger for very inactive stocks.

The figures used above illustrate that the dealer is in a position to make more money in an unlisted security than can be made through a brokerage commission in a listed security. Of course, to the extent that there is an extra cost, it must be borne by the customer. The spread in the retail bid and asked price is larger than in the wholesale, because as pointed out previously, the size of the transaction is generally smaller. Furthermore, the retail dealer does more work in contacting investors. There is a further reason why the amount going to dealers in unlisted securities is larger than the commissions for listed stocks. The specialist on an exchange generally has the advantage of trading in more active, stable and well-known companies. The spread in stocks listed only on the smaller exchanges may be higher because of the nature of those stocks. However, the essence of these comments is that dealers do tend to make more in unlisted securities, other things being equal.

It may be noted that dealers who are not members of the Exchange may make an over-the-counter market in listed stocks. In doing so, they have to compete on the basis of commissions established by the Exchange. Such competition, although limited, is not particularly enjoyed by members of the Exchange.

If you were not able to follow the above comparison of markets, summary tables are given below for the listed, and on the next page for the unlisted stocks.

LISTED[1]

| | | | | |
|---|---|---|---|---|
| Smith Sale Price | $20.00 | (Specialist spread $0.125[2] or 0.6%) | Jones Purchase Price | $20.1250 |
| Less: Brokerage Commission | 0.27(1.4%) | | Add: Brokerage Commission | 0.2713(1.4%) |
| *Net Proceeds to Smith* | $19.73[2] | | *Net Cost to Jones* | $20.3963 |

↑——(0.6% + 1.4 + 1.4% = 3.4% Difference)——↑

[1] These figures are based on commissions for a 100-share transaction for a stock listed on the New York Stock Exchange and quoted at 20 to 20⅛.

[2] Less transfer taxes, not shown.

If a stock is listed on an exchange and there is a sale, the sale price is immediately reported on the ticker. In the example above, there are two transactions and two sale prices, $20.00 and $20.125. If no sale had taken place, then the bid and asked figures of the specialist are shown: Bid—$20.00; Asked—$20.125.

In the over-the-counter market no sale prices are reported, only the bid and asked. The "Pink Sheets" would show the wholesale market Bid $20½; Asked, $21. The retail market quotations as reported in the newspapers would be: Bid, $20; Asked, $21¾. Such quota-

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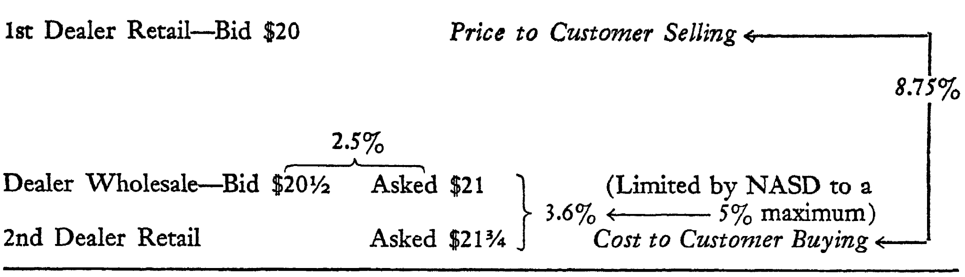
[6] Stocks priced below $10 were eliminated because they would not be comparable with the price ranges for listed securities. The spread was substantially larger for stocks with lower price ranges. The averages for all stocks in the categories used above were 12.7% for retail and 5.4% for wholesale.

[7] This limitation is subject to many variations and is defined at length in "General Review of N.A.S.D. Mark-up Policy," included in the Association's *Manual.*

OVER-THE-COUNTER


1st Dealer Retail—Bid $20
Price to Customer Selling
8.75%
2.5%
Dealer Wholesale—Bid $20½
Asked $21
2nd Dealer Retail
Asked $21¾
3.6%
(Limited by NASD to a 5% maximum)
Cost to Customer Buying

tions for the retail market are only an indication of the interest, whereas the bid and asked quotations at the specialist's post on the exchange are firm at the time.

In the above examples, particularly note the 3.4% difference in the net proceeds to Smith and the net cost to Jones for the listed stock, compared with the 8.75% difference between the price to the customer selling and the customer buying for over-the-counter stock.

In order to show you what happens upon listing, and to contrast the two types of markets, there are given below the prices of a stock before and after listing on the New York Stock Exchange. Shown is the spread between the bid and asked prices, retail and wholesale,

KELLOGG COMPANY
(Common Stock Listed on May 12, 1959)

OVER-THE-COUNTER MARKET[1]

| | Retail | | | | Wholesale | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | *Bid* | *Asked* | *Spread* | *Spread as Percentage of Bid Price* | *Bid* | *Asked* | *Spread* | *Spread as Percentage of Bid Price* | *Dow Jones Average* |
| May 5 | 40 | 43 | 3 | 7.5% | 40 | 40¾ | ¾ | 1.9% | 624.39 |
| 6 | 41 | 44 | 3 | 7.3 | 40¼ | 41¼ | 1 | 2.5 | 615.64 |
| 7 | 40½ | 43½ | 3 | 7.4 | 40¼ | 41¼ | 1 | 2.5 | 621.36 |
| 8 | 39¾ | 42¾ | 3 | 7.5 | 40¼ | 41¼ | 1 | 2.5 | 625.03 |
| 11 | 40 | 42¾ | 2¾ | 6.9 | 40 | 40¾ | ¾ | 1.9 | 625.90 |

NEW YORK STOCK EXCHANGE
(11 A.M. Quotations)[2]

| | *Bid* | *Asked* | *Spread* | *Spread as Percentage of Bid Price* | *Dow Jones Average* |
|---|---|---|---|---|---|
| May 12 | 41 | 41¼ | ¼ | 0.6% | 627.66 |
| 13 | 40¼ | 40¾ | ½ | 1.2 | 633.05 |
| 14 | 40¼ | 40¾ | ½ | 1.2 | 637.04 |
| 15 | 39½ | 40 | ½ | 1.3 | 634.53 |
| 18 | 40⅜ | 40¾ | ⅜ | 0.9 | 633.53 |
| 19 | 40⅜ | 40¾ | ⅜ | 0.9 | 635.44 |

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[1] Quotations for the over-the-counter market are as furnished by the National Quotation Bureau. The figures as shown for the wholesale market do not appear strictly comparable with those for the retail market. The wholesale quotation should be in between the retail quotations, that is, the wholesale bid should be above the retail bid, and the wholesale asked below the retail asked. The reasons that the figures as shown may not be strictly comparable may be due to the following: The retail quotations are as reported by one broker at a particular time. They are not a firm quotation, but only an indication of interest. The wholesale bid and asked are the mean averages (to the nearest ¼) of quotations furnished by a number of brokers from ten o'clock until two. (They exclude quotations received by mail which may cover the previous day). In spite of these discrepancies, they do give an indication of the difference in spread in the two markets.

[2] Quotations from Daily Quotation Sheet of Fitch Investors Service giving quotations on the floor of the Exchange at 11:00 A.M. each morning.

for the stock on the five days before it was listed, and the bid and asked quotations on the floor of the exchange at 11 A.M. on the day it was listed and the five days following. The industrial Dow Jones Averages are also given to show the general market trend for the period.

## LISTING vs. NON-LISTING

Thus far, as a matter of convenience, we have talked primarily about the New York Stock Exchange, except for the story from *The New Yorker* magazine about the specialist on the American Stock Exchange. When you get around to the question of listing, you will have to decide on two questions: First, should you list on an exchange? Second, if the answer is yes, then which ones?

There are two active national exchanges[8] located in New York, and what might be termed five major regional exchanges. There are altogether a total of twelve registered exchanges which trade in securities in the United States. They are shown below in order of importance as measured by percent of total dollar market volume of securities traded in 1959.

| | *% of Total Market Value Traded*[1] |
|---|---|
| New York Stock Exchange | 84.2% |
| American (New York City) | 9.2 |
| Midwest (Chicago)[2] | 2.6 |
| Pacific Coast (San Francisco)[3] | 1.9 |
| Philadelphia-Baltimore (Philadelphia) | 1.0 |
| Boston | 0.6 |
| Detroit | 0.3 |
| Other[4] (Cincinnati, Pittsburgh, Salt Lake, Spokane, San Francisco Mining) | 0.2 |
| | 100.0% |

[1] Data from Securities and Exchange Commission, Washington, D.C.

[2] The Midwest was a consolidation in 1949 of Chicago, St. Louis, Cleveland and Minneapolis-St. Paul.

[3] The Pacific Coast was formed in 1956 by the merger of the San Francisco and Los Angeles Exchanges.

[4] There is one registered exchange which does not deal in stocks and bonds—the Chicago Board of Trade; and there are four exempted and not registered exchanges—Colorado Springs, Honolulu, Richmond and Wheeling. The New Orleans Exchange ceased trading activities on October 30, 1959, and its registration was withdrawn on December 31, 1959.

Of the total dollar market volume traded on all exchanges in 1959, 96% was accounted for by stocks.

The New York Stock Exchange lists more than 1,500 stocks (1,100 common stocks), of which over 750 are also available for trading on one or more regional exchanges. The American deals in around 900 corporate stocks, many of which are listed on one or more local exchanges. The largest local exchange, the Midwest, provides a market for over 500 stocks, of which 90 are listed only on that exchange.

We can attack the problem of listing on the various exchanges in many different ways. We could start out by deciding whether or not a stock should be listed on a regional exchange, and then whether it should be listed on a national exchange, and if so, which one. We choose to start out in a reverse order by first trying to decide whether your stock should be listed on the largest national exchange, the New York Stock Exchange, or be traded over-the-counter.

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[8] A new exchange located in New York City was formed in 1960 by officials of the New York Mercantile Exchange. It will be known as the National Stock Exchange, Inc., and be located at 6 Harrison Street, quarters of the Mercantile Exchange.

### *National Exchanges*

Before a company can list on the New York Stock Exchange it must meet certain requirements. As a first step, we will review these requirements as summarized by the Exchange:

> By reason of their nature and the necessity for flexibility, the qualifications for listing on the New York Stock Exchange can better be described in general terms than as exact formulae.
>
> The company must be a going concern, or be the successor to a going concern, and must have substantial assets or demonstrated earning power, or both. While the amount of assets and earnings, and the aggregate market value of the company's junior securities are considerations greater emphasis is placed on such questions as degree of national interest in the company, its standing in its particular field, the character of the market for its products, its relative stability and position in its industry, and whether or not it is engaged in an expanding industry, with prospects of maintaining its position.
>
> The particular securities for which listing is sought must have a sufficiently wide distribution to offer reasonable assurance that an adequate auction market in the securities will exist.[10]

As a second step in deciding whether your company should be listed on the New York Stock Exchange, we will review the advantages and disadvantages in listing. Have in mind that the principal thing you are trying to achieve is the best market for your stock. As far as price alone is concerned, there are three elements: a narrow spread between bid and asked, an orderly market so that there are not erratic or wide fluctuations, and the best price level commensurate with the nature of your stock.

Important, particularly as regards the best price level for your stock, is a correct evaluation of the interest on the part of investors and those who trade in securities, that is, brokers and dealers. This necessitates an understanding of securities markets, which we discussed previously.

### *Advantages*

1. There are certain types of investors who in some instances limit their investments to stocks listed on the largest exchange.[11] Thus, listing may open up a new market for a company's securities and provide an added interest in a stock.
2. Concentrating all orders by members of an exchange around the specialist tends to narrow the spread between bid and asked, and provide a more orderly market.
3. Listing provides a closely supervised auction market. The specialist gives individual attention to the few stocks which are assigned to him. All transactions are reported on the ticker for everyone to see. Any wide fluctuations will be visibly apparent.
4. There are 129 daily newspapers throughout the country which report a complete list of market prices of stocks on the New York Stock Exchange, and an additional 430 newspapers which report partial listings. This is an advantage to the individual owner of the securities and also to the company. It provides publicity.
5. The system of tickers to the several

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[10] New York Stock Exchange booklet "Listing Procedure." More specifically, the requirements are:

1. A broad distribution of stock outstanding for at least 400,000 shares, exclusive of family and concentrated holdings, distributed among at least 1,500 holders of 100 shares or more after substantially discounting odd lots.
2. Net earnings of $1 million a year, after taxes.
3. Aggregate market value of the stock at least $8 million.
4. Net tangible assets of at least $8 million, but more emphasis is placed on aggregate market value.
5. Common shares must have voting privileges. Requirements for voting privileges with preferred depend on certain circumstances.
6. The existence of a class of stock which has voting rights which would tend to nullify the vote of the common would be a detriment to listing.
7. The existence of voting trusts whereby the right to vote is not lodged with the beneficial owner is a bar to listing.

[11] Some state laws governing the investment of common stock for certain institutions require that they be listed on some exchange. For example, certain common stocks, to be eligible for investment by New York savings banks and life insurance companies, must, among other things, be registered on a national securities exchange.

hundred member firms with over 2,600 branches provides quotes which can be observed by everyone, especially the great number of registered representatives in brokerage firms contacting customers throughout the country. There are a large number of dealer firms as well as brokerage firms, but the number of unlisted companies is large as contrasted with the number listed. Those that are listed may have special attention focused on them by the brokers.

6. In a proxy contest, the material sent out to stockholders is subject to certain rules laid down by the Securities and Exchange Commission as provided in the Securities Exchange Act of 1934. This tends to prevent misleading information being sent stockholders, especially by the opposition.
7. A company's common stock is automatically exempt in most states from "Blue Sky" laws if it is listed. This permits new issues of the stock to be sold in those states. This can be handled in another manner at some expense, but the automatic qualification results in savings in time and money.
8. It provides a permanent record of prices which might prove of assistance to stockholders in settlement of estates and for tax purposes, etc.
9. When a listed company desires to acquire a closely-held or family-owned company, the Exchange Market may have an appeal to the owners of the company to be acquired.
10. Banks may be more willing to lend on listed stocks.

    Banks and brokers are subject to laws regulating margin requirements.

    Bank loans to purchase or carry listed stocks are subject to Regulation *U* (Board of Governors of the Federal Reserve System), which restricts the amount of loans for such purpose when they are secured by any stocks. Bank loans to buy unlisted stocks are not subject to Regulation *U*.

    Brokers are subject to Regulation *T* (Board of Governors of the Federal Reserve System). A broker may make loans on listed stocks subject to margin requirements. However, a broker may not extend any credit whatever on unlisted stocks unless the loan is a bona fide non-purpose loan.

*Disadvantages*

1. Dealer interest is lost when a stock is listed. If dealers are members of an exchange, they cannot make a market on a negotiated basis; they must handle transactions as brokers and accept the regular exchange commission. Even if they aren't members of an exchange, their interest is mostly lost, because they have to compete with the narrow spreads on an exchange.

    When a security is listed on a national stock exchange, dealer interest is naturally lost, say the exchanges, but a corresponding awakening of interest by members, member firms, partners, and registered representatives, coupled with the public reporting of every transaction on the international ticker networks, more than makes up for the decline in dealer activity in those shares. On the other hand, the larger spread in the over-the-counter market acts as an incentive to dealers to take more aggressive action in selling a stock than is provided to a broker by the brokerage commission. This is why we took so long to show the relationship between dealer spreads and stock exchange commissions.

    If a stock was not widely enough distributed, the spread in the security could increase upon listing, since over-the-counter dealers would no longer be actively retailing the stock.

This spread should not occur if the stock enjoys adequate distribution for listing. Also pertinent is that the price of the stock which is not widely enough distributed for an auction market may be subjected to greater fluctuations upon listing, since in the over-the-counter market there may be a dozen or more firms maintaining a market which will take stock for inventory when sellers outnumber buyers, and release stock when buyers outnumber sellers. The distribution of the security must be understood in full in order to evaluate what may happen to the quotation of a security upon listing.

2. There is certain material which a listed company is required to file regularly as provided under the Securities Exchange Act.[12] In addition, the New York Stock Exchange requires that: a company provide quarterly reports (if this is predominant in the industry); it won't list non-voting common; a company must agree to solicit proxies, and shareholder approval must be obtained when additional shares are listed for certain purposes. Perhaps, from the point of view of the financial executive, the requirement of filing material may seem a disadvantage. However, stockholders are owners and information should be available. Management should not be "opposed" to stockholders in a publicly-owned company.
3. There is some cost;[13] but it appears reasonable in the light of publicity obtained and the advantage to stockholders of a fair and orderly market.

In finally deciding on whether to list or not, you will wish to weigh the nature of the two different markets for your security and what the exchange provides, as outlined above.

A large company with a broad market for its securities will generally gain more by listing. The over-the-counter market functions as a seasoning ground for new companies, some of which should eventually be listed. On the other hand, a company which is not suited to being listed and which will not gain additional stockholder interest by doing so may hurt the market for its stock by listing. The price of your stock may sag if there is not an offsetting gain in stockholder interest when the stock is listed. If the stock is suitable to being listed, such gain in stockholder interest will occur.

In carrying out our plan to determine whether or not to list, and where, if you decide to do so, we will next consider the other national exchange, the American. You cannot list on both national exchanges, and there would be no advantage in doing so, because most of the firms which are members of the New York Stock Exchange are members of the American. Much of the same basic reasoning applies in weighing listing on the American as on the New York Stock Exchange.

First, with regard to the American, there is no rigid policy as to the size of a company from the point of view of either assets or earnings. Also, there is no formal rule or policy which specifies the minimum number of shares of common stock or stockholders in order to qualify, although in general, for a common stock, there should be a minimum of 100,000 shares distributed among not less than 500 public stockholders (exclusive of the holdings of management and those affiliated therewith). Thus, many companies which would not be eligible for the New York Stock Exchange may qualify for listing on the American. Secondly, the cost of listings is only nominal on the American.

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[12] As outlined from the listing agreement form in the Stock Exchange booklet, "Listing Procedure," the company must notify the exchange of any change in the general nature of its business, changes in officers or directors, disposal of property or stock interest in subsidiary or controlled companies with material affect on financial position of corporation, changes in collateral deposited under mortgage or trust indenture, etc. It must file four copies of all material mailed to stockholders regarding any amendment or proposed amendment to certificate of incorporation, a certified copy of any such amendment, a certified copy of any amendment to its by-laws. The company must disclose in its annual report information about stock options. It must report about company-owned shares; purchases in excess of market price; action in regard to redemption, cancellation or retirement of securities; record dates. There are certain other requirements. These same requirements also apply to other exchanges.

[13] The N. Y. Stock Exchange initial listing fee for stock is at the rate of $100 per 10,000 shares or fraction for the first 500,000 shares listed, $50 per 10,000 shares or fraction for next 1,500,000 shares and $25 per 10,000 shares or fraction for shares in excess of 2,000,000. The minimum fee for listing stock issues of corporations having no other stock listed is $2,000. The continuing fee, payable annually for 15 years while stock remains listed, is likewise calculated on the basis of number of shares, at the rate of $100 per 100,000 shares or fraction for the first 2 million shares and $50 per 100,000 shares or fraction in excess of 2 million. The minimum fee is $500, or $250 per stock issue for companies with more than one issue.

If you look at the American's booklet on the advantages of listing, you will find practically the same ones given above for the New York Stock Exchange about the advantages of a supervised market, etc. There is the instantaneous ticker system providing up-to-the-minute quotations to brokerage houses throughout the country for everyone to see. Most major dailies print complete American Stock Exchange tables. Many others print partial listings.

The American does not require quarterly reports to stockholders, as the New York Stock Exchange generally does. Basically, the American is the foremost exchange for new enterprises—a national exchange on which the securities of smaller and newer corporations are eligible for listing. However, it also has many old and well-established companies. For example, as of the end of 1959, 42% of the common stocks traded on the American paid dividends for 10 to 111 consecutive years.

One point made by the American is that greater over-all attention may be given to a smaller company. There is a natural rivalry between the two exchanges and the New York Stock Exchange contends that it does not slight any company. As to this rivalry, you are undoubtedly aware that there is a similar type of rivalry between the exchanges and the dealers, who don't like to see stocks listed at all.

In making a final decision as to whether to list on the American, you will wish to go over the advantages and disadvantages as discussed under the New York Stock Exchange, with the differences, as noted above, for the American.

### *Regional Exchanges*

If you decide to list on either the New York or American Exchange, you will next have to decide whether to list on one or more of the regional exchanges. You will wish to consider only those exchanges which are located where there is an active market in your stock. The first question of importance about listing on a regional exchange for a stock which is already listed on a national revolves around whether a regional exchange will produce more interest on the part of investors and brokers without decreasing the volume on the national exchange so as to affect the market adversely. The market on the local exchanges will follow that on either of the national exchanges. A stock must be actively traded for a specialist to keep a narrow spread between bid and asked price. You would only hurt your market if listing on a local exchange pulls too much trading from New York. This is what is known as diluting your market. The specialist and other experts on the national exchange on which you are listed can help you on this point. Provided it will not hurt your market, then there might be an added advantage in listing on the local exchanges where there is an active interest in the stock. It may add to the local interest. Brokers who are members of the local exchange, but not of the New York Exchange on which the stock may be listed, have to pay the regular commission to members of the New York Exchange when they purchase or sell the stock through that route. The rules of the exchanges prohibit splitting of commissions by member firms. If it is listed on their local exchange, they can handle it themselves and get the full commission.

There is a New York State transfer tax on all sales of stock on either of the New York exchanges which amounts to 4¢ per share for a stock selling at $20 per share or more. It is less for lower priced stocks. This can be avoided for people located outside New York by going through a local exchange, if a company has a transfer agent outside of New York. However, if in putting through the transaction on another exchange you miss the market by as much as ⅛ of a point, any advantage of avoiding the tax is more than lost.

In Chapter III, there were shown the 10 companies listed on the New York Stock Exchange with the greatest number of stockholders. The major regional exchanges on which they are also traded are as follows:

| | | | | | | *Other*[1] | |
|---|---|---|---|---|---|---|---|
| *Company* | *Mid-West* | *Pacific Coast* | *Phil.-Balt.* | *Boston* | *Detroit* | *U.S.* | *Foreign* |
| American Tel. & Tel. | X | X | X | X | X | P,C | |
| General Motors | X | X | X | X | X | P,C | T,M |
| Standard Oil (N.J.) | X | X | | X | | C | B |
| General Electric | X | X | X | X | X | P | T |
| U. S. Steel | X | X | X | X | X | P,C | A,L |
| Ford Motor | X | X | X | X | X | | T,M |
| Socony Mobil Oil | X | X | X | X | X | P,C | |
| DuPont de Nemours | X | X | X | X | | P,C | B |
| Bethlehem | X | X | X | X | X | P | |
| Columbia Gas System | X | X | X | X | X | P,C | A |

If you are not listed on either the New York or American, you will have a different decision to make with regard to listing on one or more of the regional exchanges. Then the effect of the loss of dealer interest again arises. You will need to know the number and importance of the dealers in the area and their interest in your stock, and the number and importance of the brokers who are members of the exchange. For example, as previously mentioned, the Midwest has 90 issues which are listed exclusively on that exchange. Thus, listing on an exchange outside of New York City may be considered by some companies either on a permanent basis or as a transition from the over-the-counter market to the national exchanges. An issue belongs in the over-the-counter market until it reaches a size and distribution where an auction market is warranted. At this point a company should consider listing, and give thought to which exchange can best serve the company at the particular time.

You may run into the fact that some stocks are traded on exchanges on an unlisted basis and wonder what it means. Before passage of the Securities Exchange Act of 1934, some stocks were traded on certain exchanges on that basis. Those stocks were traded as all other stocks, but the companies avoided having to comply with any of the exchange's requirements. Their status was frozen with the passage of the Act. Now an exchange can apply to the Securities and Exchange Commission to have a stock traded on an unlisted basis if it is registered on another exchange, or if the company is giving such information as if it were registered; and if the stock has aroused a wide public interest and is widely distributed, leading to an active market in the locality of the exchange. A company cannot initiate or block such a move without real cause.

A correct decision on the proper market for your stock will mean dollars and cents to your stockholders in their purchases and sales and a better price level for your stock. You have an obligation to your stockholders to give it your careful consideration. You should compare your stock with others of a similar nature and size which are listed and unlisted, as regards brokerage commissions, spread between bid and asked, erratic price movements and price level. If such information can be obtained, it would be well to study the new types of stockholders which may have been added as a result of a similar type of company being listed. The exchanges issue brief booklets giving their story. They have experts you can consult on an informal and confidential basis. You should review your situation with them as a first step in deciding what decision to make. You should talk with some of the larger dealer firms to get their picture of the advantages of the unlisted market for your stock. This is not a difficult question if you understand security markets. Whatever the market for your stock, you should follow it to ascertain that a proper market is being continuously maintained. As your company grows, you should review the picture to see if any different action is required. A very large company which has a foreign interest in its stock will wish to look into the possible advantages of listing on the foreign exchanges.

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[1] The letters indicate the other exchanges on which stocks are listed, as follows: P—Pittsburgh, C—Cincinnati, T—Toronto, M—Montreal, B—Brussels, A—Amsterdam, L—London. On foreign exchanges bearer certificates, interest certificates, and deposit certificates are included.

## MARKETS FOR SENIOR SECURITIES

Our discussion of markets has pertained to common stocks. Most of the trading in bonds takes place over-the-counter. Of the value of all securities traded in 1959 on all exchanges, only 4% was accounted for by bonds.[14] The institutional investors are served satisfactorily by the over-the-counter market, except that there may be a few who only buy listed bonds. Some debt issues are listed. About 360 companies have their debt issues listed on the New York Stock Exchange, and that exchange accounted for practically all of the listed trading in bonds in 1959.[15] The listing fee is small.[16] A possible advantage is the published record of prices as a result of listing. The ticker carries bond prices. Bond prices are reported separately in the newspapers from stocks, but only a few newspapers carry these quotations. If higher interest rates encourage individual investors to go into the bond market, there may be more reason for listing.

More preferred stocks are listed because there is some interest in them by individual investors. However, the market is thin. If a company's preferred stock does have a public interest, then there may be some advantage to listing. Preferred stock prices are reported along with those for common stocks. There is one school of thought to the effect that quotations on a preferred stock will be better if it is listed, and that this will assist in getting better prices on future offerings of preferred stocks. The question of listing a preferred may be important in some instances, but it isn't such an important question as is listing of common.

Perhaps more consideration should be given to listing senior securities which are convertible into common stock on the same exchange as that on which the common stock is traded, in order to provide a comparable quotation for the two issues. This may be of some benefit to your security holders when it appears advantageous to convert. More individual investors are interested in convertibles than senior securities without the convertible privilege.

## THE UNDERWRITER OR INVESTMENT BANKER

We started with the cart before the horse by discussing the process of buying and selling and markets for already outstanding securities. New issues first have to be sold in order that there be something outstanding to trade in. Now we will reverse our field and discuss the underwriter, who is primarily involved in marketing new issues.

When you sell securities, you may sell them directly to the ultimate purchasers, but more likely than not you will deal with an underwriter. Thus, an underwriter generally will take part in the process of distribution to the ultimate investors in one way or another.

The underwriter is a middleman. He is a

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[14] Data from Securities and Exchange Commission, Washington, D. C.

[15] *Ibid.*

[16] The fee for bonds is $120 per $1,000,000 of principal amount. For short-term bonds with a maturity of 5 years or less, it is $60 per $1,000,000. There is no continuing fee for bonds.

merchandiser of securities. In his normal function, he does not wish voluntarily to continue to be the owner of the securities for any length of time. Securities are merely his stock in trade, which he wishes to move into the hands of investors with the greatest possible speed. He makes his money by turnover and not by holding. In most cases, his capital is not large enough to use for both underwriting and investment purposes.

An underwriting firm may also be called an investment banking firm. This latter term is more appropriate when referring to such a firm's over-all business, which may include financial services related to underwriting.

If you are not familiar with the investment banking business, let's look for a moment at a few figures of an actual firm. Many such firms are partnerships or closely-held corporations and there is relatively little information available about their operations. However, The First Boston Corporation, one of the largest, has stock outstanding with the public. If you choose, you can purchase its stock and invest in its business in the same way as you would in any other corporation. It is traded in the over-the-counter market since it is not listed.

The First Boston Corporation issues an annual report and some interesting facts can be gathered from it. Some investment banking firms limit their business to underwriting and related services, but most are engaged in other types of security business. The 1959 Annual Report of First Boston describes the business it does, which includes acting as an underwriter, a dealer and a financial adviser. It covers all types of securities from government bonds to corporate securities. In other words, its business is a combination of raising money for public bodies and corporations, in which capacity it acts as an underwriter; and trading in securities already issued, in which capacity it acts as a dealer. It is a typical wholesale rather than retail dealer. It is not a member of any stock exchange and therefore does not do a brokerage business.

Here are some figures on this firm for the year ending December 31, 1959:

Offices—New York City and 6 branches throughout the country.
Employees—493.
Capital structure—$22,309,833 common equity.
Earnings—$2,869,475 available for return on capital.

The earnings represented about 13% return on the capital. During 1959 First Boston managed 51 corporate syndicate issues aggregating $1,042,344,000 and 64 tax exempt offerings having a principal amount of $891,216,000. These figures do not reflect the actual commitments of the Corporation, since other underwriters participated in the great bulk of these issues and First Boston also had many commitments in issues managed by other underwriters. In addition, they do not reflect the use of its capital for trading in U. S. Government securities and the position it takes as a dealer in securities. However, they do give some indication of its tremendous volume of business. Obviously, this could be accomplished only by a quick turnover of its $22,309,833 of capital. While not requiring the use of its capital, the firm also, either alone or jointly, placed $259,968,750 of securities privately in 1959.

One of the reasons that such a large volume of underwritings can be handled with relatively little capital does not appear in the figures above. Securities in the hands of underwriters are largely financed by short-term bank loans. The banks call these loans brokers' loans, whether they are to brokers, dealers or underwriters. On high grade bonds, the banks may lend nearly the full price. The commercial bankers would not make such loans unless they expected the securities would be sold quickly and the loans repaid.

There are many different types of underwriting firms, some large, such as The First Boston Corporation, which take large positions in an underwriting, and some small, which participate on a scale commensurate with their capital. Some are wholesalers of new issues almost exclusively; they have one main office in New York and perhaps one other outside. When a wholesale type of underwriting firm buys an issue, it will sell to large institutional purchasers. If the security is a type which has to be sold to a large group of investors scattered throughout the country, such a firm will rely heavily on dealers throughout the country to assist in selling. There are other firms which have many branches throughout the country and do much of the distribution to individual investors through their own branches. There are still other firms which might be considered as in between, with a limited number of branches in key cities, such as The First Boston Corporation. A few firms tend to restrict their business to senior securities. Some are known as specialists in certain types of industries such as oil companies, department stores, etc. As previously mentioned, some are strictly in the underwriting business, whereas others may be in many other types of security business, functioning as broker, dealer, trader in U. S. Governments and Municipals, investment counsel service, etc. Some of the firms also handle trading in commodities.

Large investment banking firms are departmentalized, and when you deal with one you will find it easier if you have an idea what the different departments do. They are as follows:

*Buying or Underwriting Department*—This department handles all the operations of buying the securities from the issuing company, including developing new business for the underwriting firm, developing financial plans, framing terms of security issues, and assisting companies in setting up a financing in a negotiated deal, such as by writing the prospectus, etc.

*Syndicate Department*—Arrangements are made in this department with other underwriting firms that may participate in the underwriting of a new issue, and relations are handled with dealer firms that may assist in the sale of the issue.

*Sales Department*—This is self-explanatory. Once a new issue is set up and underwritten, the sales department handles the selling of the firm's own commitment in the issue.

*Trading Department*—This department is staffed with men sitting at banks of phones, which are connected with other firms and some institutional investors throughout the country. Don't try to tell a securities trader a new joke; chances are that he has heard it long ago, no matter in what part of the country it originated. Teletype machines are handy for further instantaneous communication. This department looks like a madhouse to someone who isn't accustomed to it. There is much shouting of bid and asked prices and other lingo of the trade, flashing of telephone lights and watching of a large board on the wall with up-to-the-minute quotations. The trading department is not a necessary adjunct of the underwriting business, but many firms have such departments because they perform functions in the securities business other than underwriting. They mostly buy and sell issues already outstanding.

*Statistical Department*—This department is staffed with expert security analysts who write reports and make various types of studies about companies, industries and securities. It is also known as the investment analysis department, the research department and the security analysis department.

There are other departments necessary to keep a large organization going, such as accounting, security handling, etc., but you will have no contact with them as far as offering securities is concerned.

As will be explained subsequently, an investment banking firm provides three related services for a company selling securities:

1. Buying the securities from the company at a specific price and on a certain date. Thus, the company gets its money. In this capacity, the firm is acting as an underwriter and has the risk and the job of selling securities to investors.
2. Acting as agent for the company if the securities are sold at private sale.
3. Acting as a financial advisor either as a

separate function or while handling a new offering.

A particular investment banking firm should have three things to offer you: people with "know-how," capital and reputation. When you choose your underwriter, these are the points you will wish to have in mind:

1. *The type of firm best suited to handle your particular offering*—Whether it is a wholesaler or retailer, with many branches or a good dealer set-up, and whether it does business in bonds or stocks.
2. *Knowledge of the personnel*—Long experience handling many deals is a prerequisite to build up adequate knowledge in this specialized business. If your business is of an unusual nature, the more experience the firm has in your industry, the better.
3. *Integrity*—This should probably be put first. Unless you are an expert in finance and right up-to-the-minute on financial markets, you will have to rely heavily on your underwriter's advice. You can only be sure that you will be fairly treated if the underwriter has the highest possible integrity.
4. *Capital*—The firm must have sufficient capital to handle your financing. However, a small company may find that its securities could better be handled by a small underwriting firm geared to such financing. This may involve the use of a local firm familiar with the situation and local investors, who would be the most interested purchasers.
5. *Sufficient staff*—You will not wish to be given summary treatment by a firm which has a large volume of business and inadequate personnel.

One thing any underwriting firm should have, if it is worth its salt, is a good "feel" of the market. It should know the instantaneous thoughts of the buyers in regard to price. It can be immeasurably helpful in this regard. Furthermore, it should be aware of the terms which investors are currently seeking. An underwriter will tell you that there are security patterns which are continuously evolving. In order to sell your security most advantageously, you should know the proper dress to put your security in, to make it appealing to investors. This is a sound approach provided due consideration is given by the company to the fact that the dress should wear well and not hurt the company's subsequent appeal when some of the security provisions come into effect in future years.

If you have a new offering of securities underwritten, you will sign an agreement with the underwriter on the day he buys the securities. Such an agreement says that he will pay you the money a few days hence on the closing day. If you read most agreements, you will note that they may include certain clauses which permit him to get out of the contract if the issue could not be sold at practically any price. Such clauses cover the company experiencing a material adverse development affecting its financial strength, a major law suit, a war or other national catastrophe, etc. These out clauses may jolt you when you first read them. They make it look as though you do not really have the underwriter on the hook. However, underwriters have to depend on their reputation in order to get business, and if they did not lean over backwards in interpreting these out clauses, their name would be mud. As a practical matter, reliable underwriters would not use them except under very extreme circumstances.

Therefore, you don't have too much to worry about. This does not mean that you shouldn't be sure that you have a very good underwriting agreement; you might be unlucky and then your contract with the underwriters would be important. Furthermore, the agreements which underwriting firms are willing to sign may vary regarding the out clauses. Some firms pride themselves in being willing to sign a tight agreement. You should read the out clauses carefully, so that at least you will know whether you are getting the protection you thought you were paying for. One thing to note is that the agreement with underwriters who act together in offering a single issue is several and not joint.

Once in a while things do happen so that a deal is messed up. One such case is described below as it was reported on the day it happened in August, 1959, by the Financial Editor of the *New York Journal-American,* Leslie Gould.

> Cancellation of the $15 million American and Foreign Power Co. bond offering—after it had been sold to the public—should give Fidel Castro and his Cuban Government something to think about. . . .
>
> The bonds were successfully sold and were bringing a premium, when Castro delivered the company a severe and unexpected blow. He decreed a reduction in power rates of American & Foreign's Cuban subsidiary.
>
> American and Foreign's common stock broke from last week's high of $14.50 to $12.50 and the new bonds, which were convertible into stocks and were offered at 100 and went to 101½, were quoted as low as 87 bid and 88 asked after Castro's decree. . . .
>
> The underwriters and the company mutually agreed that the bond deal should be called off. Before this announcement, the underwriters had canceled all trades.
>
> The bond offering was made on Tuesday, Aug. 18, and delivery of the bonds were to be made today—Aug. 27—and the company paid.
>
> Castro delivered his blow Aug. 20—two days after the successful underwriting. The underwriters promptly prepared a "sticker" and sent prospectuses with this sticker to all buyers. Another prospectus with an additional "sticker," explaining in detail what had happened, was sent out the next day.
>
> Before the deal was called off, there had been cancellations by some large investors. In light of the material change in the situation, the underwriters and the company did the right thing in calling off the deal. . . .
>
> This is believed the first such instance where there has been a material change in the business affairs of a company between the offering of a new security and the delivery date for the securities and payment.
>
> Underwriters of new security offerings underwrite the risks of the market, but not risks involved in such a material change in a company's business.

When we get to the chapters on selling securities, we will analyze the risks involved in offering a security and point out which risks the underwriters assume if the issue is underwritten. We will then discuss the charges for their services and how to negotiate with underwriters.

## ARBITRAGE

Many experienced Financial Vice Presidents have hardly heard of the word *arbitrage* as it applies to securities. It is a specialized field of finance, and in certain transactions it is quite important. If you offer securities through rights, you will need to understand it in order to know one of the forces acting on the market price during the offering. It comes into play in conversion of convertible issues and in other fields, such as exchange offers.

Definition: briefly, it is the simultaneous purchase and sale of equivalents. In other words, it is the purchase and sale of exchangeable securities for the purpose of profiting upon price differentials in the market between the equivalents. Let's take an example in the field of rights offerings to stockholders:

> A company has stock outstanding with the public. It announces that it will offer 1 new share of stock to its existing stockholders for each 10 shares held. Stockholders are given 17 days to subscribe. Assume that the market price of the stock after the rights have been issued, that is, after the ex-rights date, is $100. The subscription price is $90.

Each existing share prior to the ex-rights date includes the right to purchase ⅒ of a new share at the subscription price. The existing stockholders are issued warrants, which are pieces of paper stating the number of rights to which a stockholder is entitled as well as other information regarding the offering. Those who do not wish to subscribe can sell their rights in the market.

The sale of common stock through rights, the value of a right, etc., are all described in detail in Chapter VIII, Selling Common Stock.

However, so that you won't have to read that chapter before proceeding with arbitrage, we will say a few words about the value of rights at this stage. An owner of the rights gets a bargain. A person who has 10 shares receives a warrant showing that he is entitled to 10 rights. When he gets the warrant he can buy one share of stock worth $100 for $90, or at a $10 discount. The 10 rights are worth $10, each right being worth $1.

Now back to arbitrage—the simultaneous purchase and sale of equivalents:

> Purchase 10 rights for $1 per right, or a total of $10.
> Simultaneously, sell 1 share of stock for $100.

We are short one share of stock, that is, we sold a share which we didn't own; so we use our 10 rights to subscribe at a price of $90 per share. Thus, we purchased 10 rights at $10 and subscribed for one share at $90, making a total of $100. We deliver this share to the person to whom we had sold one share for $100. This would not be a worthwhile arbitrage because we just came out all even. It merely serves as a simple illustration.

Arbitrage in rights can just as well take place in the reverse of the above transactions.

> Sell 10 rights for $1 each, or a total of $10.
> Simultaneously, purchase 1 share of stock for $100 per share.

We have gone short the rights, since we didn't have any to start with, but we own one share of stock.

In general, there is no market risk in these two arbitrages, because there is an equivalent offsetting transaction in the market in each of them at the same time. If the market goes up or down, there will be a gain in one and an equal loss in the other as long as parity exists. There are two qualifications which need to be made to this statement. In the first place, if the market price falls below the subscription price and the rights become worthless, the arbitrage no longer holds, because one of the equivalents is eliminated. The second situation occurs when the arbitrage consists in going short rights, buying common and then covering through delivery of the stock. If, because of margin rules, more money can be borrowed to purchase stock obtained through the exercise of rights than for the purpose of purchasing stock directly, the party to whom the rights were sold may be unwilling to accept stock.

In carrying out an arbitrage, the rules of the Securities and Exchange Commission must be obeyed, as well as those of a stock exchange if the security is listed. There are some mechanics which are necessary to make these arbitrages possible. When an arbitrageur goes short stock, he may have to borrow stock temporarily in order to deliver on time. In our second example, he would have to borrow rights, and subsequently might have to reserve his position to cover. You don't need to know how these mechanics work, since they are routine matters in the financial community.

In our simple examples above, as previously stated, we just broke even. No arbitrageur could work on that basis. He would not make any money, and in fact he would lose money. In addition to the paper work in his own organization, there are expenses to be covered; and, of course, he must make a profit. There must be a sufficient spread between the rights value and the stock price to make arbitrage worthwhile.

Let's assume that a person wanted to carry out an arbitrage of 100 shares for a stock listed on the New York Stock Exchange as in our first example. He might have four or five principal expenses: brokerage fees, transfer taxes, Securities and Exchange Commission fee, interest on loans if the transaction is done on margin, and perhaps some charge for borrowing stock. The first three expenses would be as shown in the table on page 164 for a transaction taking place in New York.

In order just to cover these expenses, the rights would have to be bought for $0.94 per right and the stock sold for $100.57 per share, or at a spread of $0.63. Arbitrage cannot ordinarily be done by individuals, because the spread isn't sufficient to cover such expenses and also allow a profit. The professionals in brokerage firms do not have to pay the brokerage fees, and they can handle the transaction on a narrower spread and still make money. It is a penny business in large volume.

| | | |
|---|---|---|
| Expenses to Purchase Rights: | | |
| For 1000 Rights | | |
| Brokerage Fee | $60.00 | Per Right $0.06 |
| Expenses to Sell Stock: | | |
| For 100 Shares | | |
| Brokerage Fee | $49.00 | |
| Taxes: N. Y. State | 4.00 | |
| Federal | 4.00 | |
| S.E.C. Fee | .20 | |
| | $57.20 | Per Share $0.57 |

In calculating the spread in an arbitrage, careful attention must be paid not only to the expenses and when the stock goes ex-rights, but also to the dividend date and accruals, etc.

A word here about the justification of arbitrage. Is it a skin game in which the professionals make money and do no good? Not at all. Visualize what happens in a rights offering. Those stockholders who don't wish to subscribe sell their rights, and with the increase in the supply of rights, the price of rights would be driven down. There would not necessarily be any corresponding action in the stock. As a consequence, the stock would stay up in price as the rights fell. The two would not remain in approximate parity, which means the same equivalent value. Here is where the arbitrageurs come in. As the spread gets great enough between the rights value and the stock, enabling the arbitrageurs to make money, they will sell the stock short and buy the rights. Thus, buying comes into the market for the rights—which holds their price up. The selling of the stock short puts pressure on the stock price and tends to adjust it downward so that the rights and stock approach parity. Therefore, the arbitrageurs do perform a very worthwhile function. In fact, they are so quick to take advantage of any spread between the rights and the stock that it is seldom that any spread exists. Therefore, there is relatively little true arbitrage in rights offerings of common stocks. Remember that true arbitrage means a simultaneous transaction.

Much of the arbitrage in rights offerings is so-called "delayed" arbitrage. It is based on an expected price differential developing between the two equivalents over a period of time, due to variations in supply and demand factors. For example, you buy rights today at what you think are depressed prices, and then hope to sell the stock later on at a higher price in order to complete the arbitrage. "Delayed" arbitrage, unlike true arbitrage which is simultaneous, involves market risk during the interim while the transaction is being completed. This type of so-called arbitrage also performs an economic function in tending to level out the price movements during the subscription period. The arbitrageurs provide buying power when prices look low and provide a supply when prices look high. This has to be based on their best judgment, and, of course, there are times when they are wrong; then they may push markets out of line in their efforts to correct their error. But they have to be right more often than they are wrong or else they would be out of business. More will be said about arbitrage when we get to common stock offerings through rights.

As previously mentioned, there is arbitrage in convertible issues, and in some situations it hastens the conversion. For example, if a bond is convertible into stock, and the stock sells at a premium over the equivalent conversion value for the bond, an arbitrageur may sell stock short, buy the convertible bond, make the conversion and deliver the stock.

There are numerous other arbitrages in finance, such as in refundings, mergers, and reorganizations where one security is exchanged for another. In most of these situations, trading takes place in "when issued" securities. Where there is uncertainty as to whether the exchange will ultimately be accomplished, there may be a lack of parity between the market value of the two equivalent securities due to the risk of possible failure of the exchange. The arbitrageurs estimate this risk and make the spread between the two equivalents sufficient to cover it.

If you are involved in any financial situation in which arbitrage may occur, you will have to investigate how the arbitrageurs will be operating in order to understand the market action for your securities.

We almost forgot to say who are the arbitrageurs. Of course, anyone who wishes to do so can arbitrage, but, as explained above, it cannot be made a profitable operation by the individual investor who must pay brokerage fees. It is a large volume operation done on narrow margins by the professionals, meaning firms engaged in security trading. While many firms do some arbitrage business, it is a specialized field. Among the leaders in the field are three large Wall Street firms which are members of the New York Stock Exchange: Goldman Sachs and Co., Josephthal and Co., and McDonnell and Co. Arbitrage is, of course, only a part of their business.

## RATING AGENCIES

There are three organizations in New York City[17] which assign quality ratings to securities, as was explained in Chapter II:

Fitch Investors Service[18]
Moody's Investors Service
Standard and Poor's Corporation

They are the three so-called "legal" rating agencies. The reason this term is attached to them, is that their ratings are referred to in laws which govern the legality or eligibility of investments for certain institutions.

Ratings are primarily thought of in terms of debt securities, because all three agencies assign comparable ratings to that type of security. Fitch similarly rates preferred and common stocks. Moody's does not rate equities. Standard rates preferred stocks and it also rates common stocks but on a different basis.

Ratings reflect in part the financial policy followed by the management. They give a good indication of the company's ability to borrow and the approximate cost of debt money. When a company sells a bond, the management, the underwriters and the potential buyers of the securities are all vitally interested in the rating assigned to it. Indirectly, debt ratings are a clue to the quality of equity securities. In all, they are a valuable tool in various phases of finance, as pointed out in Chapter II. They have become so much a part of finance that they are an integral part of financial jargon.

The executives of some companies have made "uncomplimentary" remarks about the agencies, out of their hearing, of course, when the securities of their companies did not receive the ratings to which they deemed them to be entitled. This is to be expected because everybody loves his own baby. Furthermore, there is some misunderstanding regarding ratings and how the agencies operate. A few people in high finance have pooh-poohed ratings. Be that as it may, a rating is the stamp of the long-term credit standing of a company.

The rating symbols used by the three agencies, from high to low quality, are:

| *Fitch* | *Moody's* | *Standard* |
|---|---|---|
| AAA | Aaa | AAA |
| AA | Aa | AA |
| A | A | A |
| BBB | Baa | BBB |
| BB | Ba | BB |
| B | B | B |
| CCC | Caa | CCC |
| CC | Ca | CC |
| C | C | C |
| DDD | | DDD |
| DD | | DD |
| D | | D |

Standard uses a different type of symbol for both its preferred and common ratings. Fitch uses the same type of quality rating for stocks.[19] As explained in Chapter II, for purposes of this book you can forget the ratings of *B* and lower for debt issues, because they are too speculative.

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[17] Fitch Investors Service, 120 Wall Street, N.Y.C. (5); Moody's Investors Service, 99 Church Street, N.Y.C. (7); Standard and Poor's Corporation, 345 Hudson Street, N.Y.C. (14).

[18] Fitch Publishing Company, Inc. sold most of its publications to Standard and Poor's Corporation in September, 1960. Fitch Investors Service will continue to operate an investment advisory service, assign its ratings to securities, and provide other services for investors. It provides a publication showing its rating—*Fitch Securities Ratings.*

The agencies work completely independently and are jealous of their own ratings. However, the debt ratings are comparable in the same category. Rather than use the symbols of one agency, the terminology in the Street may be:

Triple A
Double A
Single A
Triple B
Double B
Single B

In this book, we use this nomenclature when no reference is made to any one of the agencies. For the ratings of a specific agency, we use the agency's symbols.

How did the ratings of these agencies get to have such significance? Their use grew slowly at first and then rapidly after the bankruptcies in 1930. Years ago, these organizations were in the business of furnishing published information and advice to investors on securities. In order to assist their clients, they devised the symbols to designate the investment quality of securities, that is, the extent of assurance of payment of principal and interest. Then, as laws were established with regard to the quality requirements for investments of certain institutions, the lawmakers latched on to these ratings to assist in defining the investments to which the institutions should be restricted.[20] For example, as a first test, most commercial banks are restricted in the purchase of bonds to those rated *Triple B* or better by two or more of the agencies. Bond amortization requirements of some life insurance companies are linked with ratings; a bond which is rated in the first four classifications may be fully amortized. Others may have to be carried at market.

Now the agencies have a responsibility which they never expected. They receive no money for the ratings directly. These are of value to the agencies primarily from the point of view of prestige and as an aid in the sale of the published services, which include the ratings.

Ratings are limited to publicly-held issues. That means that the agencies do not rate issues sold privately. There is an obvious reason for this. If an institution is sufficiently well informed and adequately staffed to purchase a security privately, it does not need the assistance of ratings. Furthermore, ratings are for the purpose of serving a broad group of investors and there are only a few investors in a private sale. If an issue originally sold privately is subsequently resold to the public, then the agencies will rate it.

Issues of new and untried companies usually are not rated because there is no record on which to base a rating. A company usually must have an operating record for at least three years in order to be rated, but this does not always hold for Standard. It depends on the character of the company. Corporate debt issues are generally not rated by Fitch if they are under $500,000, not by Moody's if under $600,000, as a class, and not by Standard if under $2,000,000. There are a few types of companies having large enough issues and a sufficiently long record which are not rated for special reasons.

### *How Ratings Are Made*

Ratings in each agency are the considered opinion of a rating committee. They are based on a careful analysis of all factual information amassed by the agencies and on their experience. They study all the statistics, ratios, history of the company and the industry; talk with management and even competitors; and then arrive at a rating on the basis of judgment.

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[19] Fitch Investors Service states that their stock ratings have a special significance for stocks of American companies listed on the Amsterdam, Frankfort, and Hamburg stock exchanges. In order for such stocks to be listed on those exchanges, they must have a rating of *B* or better by Fitch. Also, as a matter of policy, certain institutional investors in the U.S. require a certain rating by Fitch for stocks to be eligible for their funds.

[20] In 1938 the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Controller of the Currency adopted the rating system as a guide to commercial bank purchases of corporate bonds.

The rating agencies attempt, in so far as possible, to make ratings comparable not only among companies of the same industry but among industries.

Management may be puzzled at times when a statistical comparison shows two companies to be very similar and yet to have different ratings. The shadings between a high *Single A* and a low *Double A* may be very thin, but it is the analysts' experience and judgment rather than pure statistics which will put the issue in its particular class. As stated above, each of the agencies determines the rating it will put on a security entirely independently of the other agencies. Yet, if a comparison is made of the ratings of these three services, it will reveal how closely they agree.

If you want to know how ratings are made, don't ask someone in one of the agencies, "What formula do you use?" Even if they don't show it, their reaction will be slightly jaundiced. The first thing that they will tell you is that there is *NO* formula. You can quiz them until they and you are blue in the face as to what ratios, etc., make a *Triple A, Double A,* etc., and you will get nowhere. This is not to say that capital structure ratios, earnings coverage and certain other ratios are not vital in arriving at an answer. The agencies have selected numerous statistical tests to serve as points of comparison between one issue and another. But the weight given to each one may vary with the circumstances, and for this reason the agencies themselves will not say specifically what the ratios should be. There are various factors involved which cannot be reduced to figures. For certain types of companies, where there is relative uniformity of operations and risk, there may be some recognizable correlation between ratings and such a ratio as debt to total capital structure, but it is up to you to make some comparative analysis to find it out.

Junior debt will generally be graded at least one notch lower than the senior debt, even though there is only a smaller amount of junior debt and even though it matures before the senior debt. Maturity does not affect Moody's ratings. If the maturity is very short, it sometimes may influence a rating by Fitch and Standard. If there is a large amount of junior debt, it may be rated more than one notch lower. Junior debt may reduce the rating on the senior debt if it so adds to the total debt burden of the company as to adversely affect the company's financial strength.

As previously noted, Fitch uses the same symbols in rating stocks. You may wonder why a company with one issue of debt rated *AA* might have its common stock rated three notches lower, *BB*. This is because Fitch feels it is necessary to leave "slots" in between, in case the company subsequently issues additional securities. This may be somewhat difficult to understand, but in any event it is the way an agency may operate.

The market price of securities does not have any effect on ratings. The agencies may note any substantial change in the market price of a company's securities and it may suggest to them to look into the matter of ratings, but it is not taken into account in assigning the rating. In other words, the reverse is the case: ratings affect the market, rather than the market affecting the rating.

The ratings are continuously under review by all the agencies. When there is new debt financing, close attention is paid to the effect on the capital structure, and at such times a special review is made. However, ratings are not changed unless there is a definite, non-transitory change in factors affecting the rating. This is because the ratings are established for lasting quality. The theory is that if the ratings are soundly arrived at, then they should be rather constant, unless there is a marked permanent change in the company's position. The analysts have carefully reviewed a company's financial policy and character before assigning the rating. They do not find it necessary to modify the rating whenever a few figures get out of line. Some investors buy securities by their ratings and would be confused if there were rapid changes. The agencies recognize their responsibility to investors and try to decide upon a rating with the long-range view in mind.

The slowness of change in ratings is one of the things that results in annoyance on the part of company executives. When their company's position improves, they expect the agencies to immediately upgrade the rating. This is seldom done. The agencies wish to make certain that the change is a permanent one, and time alone proves this to the agencies.

Companies fail to realize that the slowness of upward change in ratings works to a company's advantage when a company's credit temporarily deteriorates either because of poor operating results or the temporary addition of an excessive amount of debt. The agencies will listen to a company's story in such a situation and consider whether it is temporary in nature.

Generally, a company will not know when a change is going to take place. If one of the agencies is about to lower a rating and feels that it does not have sufficient information, it may contact the company and ask if there is any explanation for adverse developments which justifies a continuation of the existing rating. On the other hand, if they feel that they have all the needed information, they will act. As the ratings can be made only by judging the available facts, it can readily be seen that a lack of information may result in errors in investment judgment. This highlights the importance of a company keeping in close contact with the agencies and continually providing them with all the facts.

Do not try to pressure the agencies or oversell them on ratings. They have had too much contact with companies to be fooled. They have just as much interest in assigning a proper rating as you have in receiving the correct one. You should only want the rating which truly represents the credit standing of your company. Since the ratings are used as an indication of risk involved, it is only fair to your security holders that the rating be accurate. A rating too high would be just as bad as one too low from this point of view.

Don't overlook any one of the three rating agencies. If the rating on the debt of your company by one of the agencies is lower than by the other two, there is what is called a split rating. This tends to pull the over-all quality down. A composite rating is a term often used in financial circles when such a situation exists. The composite rating is the rating of the two alike ratings. For example, if the ratings are *AA*, *AA* and *A*, the composite rating would be *Double A*. Should either of the *Double A* ratings be lowered, then the composite rating drops to a *Single A*. Thus, it can be seen why it is important to pay attention to all of the agencies.

### *Publications and Investment Advisory Services of Agencies*

The agencies make their money from the great mass of written material which they provide to investors, and from fees for advice to investors.

Actually, the basic function of these organizations is to gather and present complete data on all fields of investments. Their printed services are among the most comprehensive sources of information available of their kind. They are the encyclopedia for people interested in investments. The factual publications include manuals, corporation records, current supplementary services and bond and stock quotations guides. They publish current guides to investors. These guides are weekly releases giving opinions on individual issues of stocks and bonds and also on general market conditions. Thus, the material ranges from pure statistics and description about various types of investments and industries to specific recommendations on securities and securities markets.

All the services are widely used in the financial districts for determining investment policy, for appraising security prices of both seasoned and new offerings and for gaining much other financial information. The agencies' importance can be illustrated by enumerating the audience reached by their services. The publications mentioned above are consulted by every type of investor—institutional and individual, informed and uninformed. Among the subscribers are: banks, insurance companies, investment houses, pension trusts, industrial corporations, brokers, managers of investments—in short, everyone dealing with any phase of finance.

As a supplement to their publications, the agencies are continuously answering telephone and written requests for up-to-the-minute information and advice about specific securities.

In addition to collecting information, these three organizations act as investment advisors for a fee. Numbered among their clients are banks, college endowment funds, insurance companies, pension funds, investment funds of corporations, foreign investors, individuals, etc. To give you an idea of the magnitude of this particular function, one of the agencies alone supervises investments aggregating over $3,000,000,000.

Therefore, when you think of these agencies and what they mean to you, be sure that you think of the three fields in which they are important:

> The ratings, which will establish your credit standing.
>
> The vast amount of written material which they may send out about your company and which may be more widely read than your annual report and the other material you send out yourself.
>
> Their recommendations to their many clients and subscribers regarding your company's securities—to buy, hold or sell.

These agencies are among the most important to keep informed about your company's operations. You should know how they operate, what information they want about your company and how they want it. That is what we will now discuss.

### *Contacting the Agencies*

The method of contacting each agency is somewhat different. It also depends on the type and size of company, but some generalizations can be made.

Your aim should be to give the agencies all the facts about your company, whether good or bad. They will treat any information as confidential if you ask them to do so. Some companies that operate in a complicated type of business have found it worthwhile to prepare elaborate statistical booklets on their operations for the special use of the agencies.

In sending in regular written material, you can address it to the library of each organization. The library will route it to the person or persons who will be concerned with your company. Then it will be added to their extensive files on company information. But be sure that the information is pertinent, and will have some bearing on the outlook for your securities. If something unusual happens, be sure to keep them informed.

After material about your company is prepared for inclusion in their manuals and corporation records, they will send you a copy to check and for suggestions. You should treat this as a real opportunity. You should go over it promptly; they have a publishing deadline to meet. If you do not do so, they will use the material as is and there may be something you could have corrected, added to or changed which would better present the facts. Of course, you must accept that they will be the ones to decide whether to include any material you suggest.

Make personal calls on them according to the nature of your company and as they indicate a desire to see you. If you are located outside of New York, you might consider writing a letter when you come to New York, saying where you will be staying and can be contacted if desired. Or you might enclose a return postcard on which they can indicate if they wish you to call while you are in New York. If you feel it necessary to see them, arrange an appointment by phone. Don't pester them with too many calls, but don't ignore them. Remember that they are as busy as you are, and recognize this in your contact with them. Attention to details will help in your relationship with the agencies. For example, if you invite them to luncheon, they may not wish to take two hours. In order to save time, you might find that arranging for a place to eat close to their office would be appreciated.

In these personal calls, you should keep your ear open for prejudices or concerns which they may have about your company. You will gradually have to overcome them by continually presenting the facts. It might be well for you to follow what they say about your company in their opinion services.

Each agency operates differently, and there is some difference in the same agency among industries. For example, at Moody's, if you see the analyst covering your company, he will be interested both from the point of view of the rating of your debt securities and the outlook for your common stock. At Standard, the group following the common stocks are separate from the bond experts, although they both sit on the rating committee. You should see both if you have both securities publicly held. In other words, be sure you see all the necessary people who might have an interest in any of the securities of your company.

Standard is the only one with a field staff stationed throughout the country. This staff is mostly stock-minded. They will study a company's territory, properties and management. Then they report their findings and opinions back to the company. The information that is gathered in this way will be passed on to the bond analyst. If a field representative contacts you, be sure to give him adequate time.

If you offer securities at competitive bidding, send the agencies prospectuses and other material as soon as it is available. Be sure to determine whether they wish you to pay them a visit before the sale date, after they have had an opportunity to digest the material and before they hold their committee meetings to assign a rating. In order to determine the correct day for your visit, be sure to make an appointment by phone well in advance. If you offer securities on a negotiated basis, the underwriting firm will arrange these meetings.

There are other financial organizations which assign some form of rating to securities. You may find that some of them should be included in your investor relations program. However, the agencies just discussed are the only ones which have significance attached to them because of their use as guides to eligibility of investments for certain institutions. Furthermore, as explained above, they have an extensive subscription list of investors.

### *Summary of rating agencies*

If you have not had any experience in contacting the agencies, perhaps a brief summary might help to orient your thinking. If yours is a large, publicly-owned company with no long-term debt, or with long-term debt held privately, you will want to pay close attention to the agencies primarily because of the material they publish about your company, the recommendations they will be making and the fact that they may hold your securities in their advisory accounts. But remember that Fitch rates equities the same as it rates debt issues and Standard has a special method of rating common stocks. If your company, in addition, has long-term debt publicly held, you will have some additional contacts to cover.

As the size of your company decreases, so will the attention that these agencies give to your company and the attention that you will have to give to them. But no matter how small, as long as you have securities publicly held and the agencies include information about your company in their manuals and other publications, you will wish to be sure that they are given all the necessary information.

## SECURITY ANALYSTS AND THEIR PROFESSION

An understanding or "feel" of security analysis, that is, how it is performed, is a necessary background for finance.[21] Security analysis is the method by which the price of your "commodity" is established, and you will wish to know how that is done. If you get into finance very deeply, you will be making price estimates yourself, or at least studying estimates made by someone else. If you cultivate the analysts by keeping them informed about the operations of your company, you will do a better job by appreciating how they try to perform their job. What follows is a simplified statement of how a security analyst works.

The purpose of security analysis, or financial analysis, as it is also called, is: to determine the characteristics of a security and its appropriateness as an investment for various types of investors, and the value of a security, in order to decide whether it should be bought, held or sold at a particular price.

There may be other supplementary reasons for security analysis. The rating agencies study a security in order to evaluate the risk and place a rating on it. Underwriters study a security in order to determine whether it is the type that they should underwrite, and the price which they should pay as intermediaries in the distribution of securities. But the ultimate aim is as stated above.

The forces which will change the value of a security must make themselves felt through the balance sheet and income statement of a company. These are the two usual starting places. First of all, what security is the analyst studying—a senior security or common stock? Let's assume that our company has three types of securities outstanding—bonds, preferred stock and common stock.

After glancing at each security to see its type, the next consideration is of how much of the capital structure each represents; that gives the analyst an immediate idea as to whether there is a heavy or light burden of senior securities. For example:

| | | | |
|---|---|---|---|
| Bonds—First Mortgage 5%, due 1985 | | $20,000,000 | 20% |
| Preferred—6% Preferred Stock, $100 Par Value | | 10,000,000 | 10 |
| Common Equity—Common Stock, 1,000,000 shares, | | | |
| No par at State Value | $50,000,000 | | |
| Capital Surplus | 10,000,000 | | |
| Earned Surplus | 10,000,000 | | |
| (Book value per share common stock —$70.00) | | 70,000,000 | 70 |
| TOTAL | | $100,000,000 | 100% |

Other things being equal, the percentage figures give a picture of the protection afforded the debt by the size of the preferred and common equity and, correspondingly, the risk added to the common equity by obligations having a senior position. But all other things are practically never equal. As explained in Chapter II, a relatively stable, well-situated electric company may have as much as 45% debt to total capital structure and be rated *Triple A*, while most large industrial companies with that much debt would receive a very low rating on their bonds.

So from here on the security analyst has to start to work. The analyst will study the balance sheet carefully to discover what the assets consist of, whether they are properly stated, whether there are sufficient reserves, whether there are any items of dubious worth on the asset side of the balance sheet, whether assets are leased or owned, etc. He will need to know the principal terms of each security. He will look for non-recurring items in the income statement and make allowances for them. But assets generally aren't worth much unless they can earn; so the analyst is primarily interested in the prospects for earnings.

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[21] If you are interested in security analysis, some of the books on the subject are: *Security Analysis—Interpretation of Financial Statements* by Douglas H. Bellemore, published by Simmons-Boardman Publishing Corporation, New York, 1959; *Investment Analysis and Management* by Lester V. Plum and Joseph H. Humphrey, Jr., published by Richard D. Irwin, Inc., Homewood, Illinois, 1951; *Security Analysis* by Benjamin Graham and David L. Dodd, published by McGraw-Hill Book Company, Inc., New York, 3rd edition 1951.

For bonds, the analyst is ultimately interested in the number of times that earnings available for interest payments cover those payments. Many analysts prefer a pre-tax coverage; others use the after-tax figure. For preferred stock, the test is the number of times earnings, after taxes available for interest, cover both interest and preferred dividends. For common stocks, the ultimate aim is the earnings per share. These figures can be illustrated in simplified form as follows:

| | | |
|---|---|---|
| Total Income | $21,000,000 | |
| Interest | 1,000,000 | |
| Federal Income Taxes, assuming a 50% Rate | 10,000,000 | |
| Net Income | 10,000,000 | |
| Preferred Dividends | 600,000 | |
| Common Dividends (1,000,000 shares) | 4,700,000 | |
| Balance after Dividends | 4,700,000 | |
| Times Interest Charges Earned, before Income Taxes | | 21.0 |
| Times Interest Charges Earned, after Income Taxes | | 11.0 |
| Times Interest Charges and Preferred Dividends Earned | | 6.9 |
| Earned per Share Common | | $9.40 |
| Dividends per Share Common | | $4.70 |
| Dividend Payout Ratio for Common | | 50% |

Now the analyst's heavy work really begins. He will have to try to find out the amount of earnings that will continue to be available to service the company's securities and their stability. He will want to consider every factor which might increase or decrease these results —possibilities of increasing or decreasing sales and expenses. In order to do this, he will need to understand the industry and its prospects, the nature of the company and how it stands in the industry.

The approach in bond analysis is somewhat different from analysis of the common stock. In bond analysis, the analyst is interested in determining that both assets and earnings are sufficient so that interest and principal payments will be assured, but, more important, that the quality of the security will be maintained so that the bonds can be sold at satisfactory prices in the market.[22] The same applies to preferred stock analysis.

For common stocks, the analyst must perform a more difficult task. He must determine the prospects for the earnings per share, because it is primarily those prospects which affect the value of a common stock. Future dividends will come from those earnings, and the amount of earnings plowed back in the business will build up the investment. Common stock analysis is much more difficult, because the analyst is dealing with the last security out on the limb, and it is the future residual left over to the common which will determine its value. Bond analysis is more of a defensive type of analysis—its purpose is to determine whether there are sufficient assets and earnings behind the bonds to assure protection.

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[22] A check list used by one institution included the following items:

Organization and History. Major developments in past five years.  
Products and relative importance of each. New Products. Research.  
Customers and selling methods. Importance of large units. Dependence on a few large customers.  
Industry: % position. Competitive situation.  
Raw material requirements and position. Inventories.  
Properties: Size. Location. Condition. Insurance.  
Operations and earnings for at least ten years. Depression record.  
Sales and Profits by Divisions.  
Financial position and practices. Usual financial ratios.  
Forecasts and budgets. Purpose of Financing. Is financing adequate? Free of bank loans except seasonal?  
Capitalization: % debt, including leases capitalized.  
Patents. Franchises. Legislative restrictions.  
Litigation.  
Management.  
Board of Directors.  
Trade Checks.  
Independent Engineering Reports.

Does all this sound easy? Perhaps it does, but it isn't. The management of a company, knowing all about its operations, may find it most difficult properly to evaluate the risks in the business and the outlook; yet the security analyst, on the outside, must do just that. Security analysis is far from being a science. The analyst will start off with a very scientific approach, if he is a good analyst, by making a thorough study of all factors affecting a company, and in his analysis he will subject a company's balance sheet and income statement to any number of ratios in order to bring out various relationships. However, in the end, the final result is a matter of judgment.

Since security analysis is not an exact science by any stretch of the imagination, there is no set pattern of analysis followed by all analysts. Many analysts use different types of ratios.[23] As an example, which has already been mentioned, some will figure interest coverage before Federal Income Taxes whereas others will figure it afterward. However, whatever ratios they use, they will always have in mind how they were calculated when weighing their significance; so there is compensation for their different approaches. Furthermore, an analyst will be consistent in his application of ratios from one company to another.

The price of a security is generally looked at first in relation to prices of other securities. What is its relative value to other securities, with due allowance for any difference between the securities? Is it over, under, or reasonably priced? In other words, is it attractive as compared to other securities? As an aid in determining relative values, analysts often make a statistical stack-up or comparison of one security with a number of other securities. Such a comparison will include the principal ratios, which show important relationships in balance sheet and income statement figures, as well as some operating statistics. If a company official should study such a "stack-up" or make one himself, he might wonder why the prices of the securities did not conform closely to relative values as shown by the ratios. The answer is as already stated: the ratios are only to aid in interpreting the picture which each company presents. For example, one important element in analyzing a security, not yet mentioned, is the quality of management, particularly for common stocks. An appraisal of management cannot be put in figures.

You, as an executive of your company, may question how security analysts can place a value on your company's securities when they don't have more than what may appear to you to be a superficial knowledge of your company and the industry. This observation on your part may be correct. But remember, there is something they do have if they are good analysts, and that is a broad knowledge of many companies and relative values of securities, gained through long experience. The more the analysts know about your company, the better, but without the broad knowledge they would not be able to weigh the relative values. Some of the questions they ask you may *seem* foolish and may well *be* foolish. They may even be groping for the right question to ask. You may not see fit to answer all their questions for a very good reason.

Company officials at times are prone to criticize security analysts, and say that equally good results could be obtained by flipping a coin. There are good, mediocre and bad security analysts. Be as critical as you wish about security analysis; nevertheless, it is only through security analysis that at least an approach can be achieved towards the proper evaluation of a security. It is far better than the way many investors buy and sell stocks, without any effort at analysis whatsoever, but merely on the basis of general optimism or pessimism or some "inside" tip.

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[23] For the types of ratios used in security analysis you may refer to the books on security analysis in the previous footnote. It may be noted with regard to the three rating agencies that Moody's Investors Service Manuals include some definitions of ratios, as does Standard and Poor's Corporation in its booklets "Earnings and Rating Bond Guide" and "Security Owner's Stock Guide."

Furthermore, whether you like it or not, someone is going to perform that function as long as we have a system of private capital. Your contact with security analysts will be greatly facilitated if you appreciate what they are trying to do, the difficulty of their task and its importance to your company and our economy.

## BUYERS OF SECURITIES

Investors who have capital with which to buy long-term securities will have various aims to accomplish in order to meet their special needs, such as:

Fixed income with little risk, and maximum security of principal
High income, with willingness to take the necessary risk
A balance between income and appreciation of principal
Primary emphasis on appreciation of principal
Maturity preferences—short *vs.* long
Marketability
Tax exemptions
Legal limitations as to type and quality

Certain investors, for example, some institutions, may be subject to laws which prescribe the fields in which they can invest, and the securities that they can buy in those fields, as well as whether the securities have to be listed on a national exchange.

What investors your securities will appeal to will depend on the circumstances surrounding your company and its securities and their relative attractiveness compared to other available media for investment.

You may wish to have an understanding of the types of investors who might be potential purchasers of your company's securities. This will assist you in your investor relations program, which is covered in Chapter IX. It will assist you when you make plans to raise new capital.

Your best clue is to analyze your existing security holders. For your common and preferred stock, you should consult your stockholder list. Some of your stock may be held in nominee names by banks. You cannot find out who are the real owners, but by talking with the banks you may get a general idea of the type of investors they represent. If your bonds are registered, you can readily find out who owns them. If they are not registered, you may be able to obtain some information from compilations of holdings of certain institutional investors.[24]

Your present investors may have all they want of your securities or they may find that another field has become more attractive. Therefore, you may have to attract other investors to provide your new capital requirements; so you need to know potential investors as well. We will discuss briefly the different broad classifications of investors.

The institutional investors purchase the greatest amount of new corporate issues and are particularly important for senior securities. The individual investors become more important for common stocks. Some figures will follow.[25]

Of course, some of the institutions have securities outstanding, which are, in turn, owned by individuals. For example, investment companies are considered institutional investors; yet they, in turn, have securities outstanding which are owned by individuals. Pension funds, run by institutions, are for the benefit of individuals. So, in the end, much of the income and ownership is ultimately for the benefit of the individual. The distinction between the two rests primarily on whether the securities are owned directly by the individuals, or indirectly through some institution which has the responsibility for directing the investment.

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[24] *Corporate Holdings of Insurance Companies* (life, fire and casualty), compiled by United Statistical Associates, Inc., 135 Front Street, New York 5, N.Y.; issued annually, price $175.00. For information on holdings of investment companies, see material on page 184 under "The National Association of Investment Companies."

[25] Data on total purchases of corporate securities by types of investors may be reported on various bases. Differences may be due to allowance for sales as well as purchases, and for changes in holdings due to repayments, etc. Such factors may account for substantial differences between apparently similar figures.

### *Individual Investors*

The individual investors are those who chart their own course or rely partially or completely on assistance from a broker, a dealer, a written advisory service or an investment counsel firm. They may invest directly in a private company, or purchase publicly-traded securities.

As a result of a survey of individual shareholders, the New York Stock Exchange came up with the following information:[26]

> There are 12,490,000 individual (1 out of 8 adults) share owners (52.5% women) in America in 5,100 publicly owned corporations. These companies have 10.2 billion shares outstanding, almost one-half of which are listed on the New York Stock Exchange.
>
> The average share owner has a median household income of $7,000. Adult share owners are almost equally divided among those who attended college and those who did not. They first acquired stock in the following ways:

| | *Number of Shareholders* | *Percentage of Total* |
|---|---|---|
| Bought through Broker[1] | 6,080,000 | 49.5% |
| Through Company Worked for | 2,592,000 | 21.1 |
| Bought through Bank | 1,585,000 | 12.9 |
| Gift or Inheritance | 1,560,000 | 12.7 |
| Other | 381,000 | 3.1 |
| Don't Remember | 86,000 | 0.7 |
| Sub-Total | 12,284,000 | 100.0% |
| Not Classified by How First Acquired Stock | 206,000 | |
| | 12,490,000 | |

[1] The term includes dealers as well as brokers.

Another study of the individual stockholder was made by the Survey Research Center of the University of Michigan.[27] This study was based on a family basis rather than an individual basis. It covered a sample of 4,773 families. Some of the data produced by that survey, which provides some interesting additional information, was as follows:

> Slightly over 14% of American families own publicly-traded common stocks, and 3% hold stocks in privately held firms only.
>
> Distribution of ownership of publicly-owned companies by stock-owning families:

| *Family Income* | *Stock Owners. As % of All Stock Owners* | *Share of Total Value in Each Group, %* |
|---|---|---|
| Under $5,000 | 18% | 10% |
| $ 5,000 to $9,000 | 42 | 26 |
| $10,000 to $14,999 | 23 | 22 |
| $15,000 and over | 17 | 42 |
| | 100% | 100% |

> About 40% of all stock-owning families have shares in one single corporation. It is estimated that only 20% of the stock owners have a diversified portfolio of seven or more stock issues.

The most encouraging thing about the University of Michigan Survey was the conclusion that over the last few years "stock ownership has had a tendency to spread to broader groups of the population."

If you are thinking of individual investors, consider whether your company's stock appeals to the conservative or speculative type of investor or whether it lies somewhere in between.

### *Institutional Investors*

Since we are thinking of institutional investors as those organizations which supervise a large amount of money, the range is great as to their type and investment objectives. We will use as an example the life insurance companies to discuss briefly how the nature of the institution affects its investment policies. Their holdings of long term corporate securities at December 31, 1959 were as follows:[28]

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[26] *Share Ownership in America: 1959.* Published by the New York Stock Exchange.

[27] *1960 Survey of Consumer Finances* conducted by the Survey Research Center of the University of Michigan.

[28] From *Life Insurance Fact Book 1960,* page 71 FF, Institute of Life Insurance, 488 Madison Avenue, New York 22, N.Y.

| | *Corporate Security Holdings (000,000,000 omitted)* | | | |
|---|---|---|---|---|
| | *Debt* | *Pfd./Com.* | | *Total* |
| Life Insurance Companies (All Legal Reserve U.S. Cos.) | $45.3 | $1.6 | $3.0 | $49.9 |

The life insurance companies have fixed obligations to meet which can be predicted actuarily. They need fixed income with safety of principal and are primarily interested in fixed income senior obligations. They prefer long-term debt maturities rather than short, and are not too much concerned with marketability.

Insurance companies are governed by state laws where they are incorporated and where they sell insurance. They are limited in the amount of preferred and common stock that they can purchase. In New York, there are minimum limitations for an investment to be eligible regarding the relation of earnings history to fixed charges, etc. However, it would seem likely that the Insurance Commission would look askance at an insurance company which did not have a predominance of investments of better quality. Other special features of state insurance laws will affect investment policies. As previously mentioned, when a security is offered for sale, it is important that a determination be made of whether it will comply with such legal requirements for different types of institutional investors, so that the underwriters and dealers will not miss a potential market. This is usually done by the lawyers for the underwriters.

Insurance companies purchase securities either at public sale or privately. Cash for investment in corporate securities comes principally from three sources: the net increase in policy reserves, from premiums and investment earnings; maturing investments which they hold; and possible sale of government or other securities. At present, the first two sources are running at an approximate rate of $5 billion and $4 billion respectively. The policy of selling governments will depend on the price of governments, the amount the companies hold and the relative attractiveness of corporates and other media for investment. After World War II when the companies held an unusually large amount of governments and when interest rates were low, the sale of governments and replacement by corporates represented a very substantial market for corporates, but this market has dwindled in recent years.

| | *Corporate Security Holdings*[1] *(000,000,000 omitted) December 31, 1959* | | | |
|---|---|---|---|---|
| | *Debt* | *Pfd.* | *Com.* | *Total* |
| Mutual Savings Banks | $4.0 | ——$0.8—— | | $4.8 |
| Corporate Pension Funds | 12.8 | 0.7 | 7.7 | 21.2 |
| Fire and Casualty Insurance Companies | 1.6 | 8.4 | 0.8 | 10.8 |
| State and Local Gov't Retirement Funds | — | — | — | 6.4 |
| Open-End Investment Companies | 1.1 | 0.7 | 13.2 | 15.0 |
| Commercial Banks | 3.0 | —— 0.2—— | | 3.2 |

Size of individual investments will vary. The largest amount of corporate bonds held by one insurance company in any one investment is approximately $250,000,000. The large life insurance companies will consider investments of as little as $300,000, and there are many smaller life insurance companies which might be interested in $50,000 to $100,000 of bonds.

The requirements and restrictions of other institutional investors may be quite different from those of a life insurance company. We will not describe any others even briefly, but given on page 176 are the holdings of corporate securities for some of the other important ones. Some institutional investors hold large amounts of corporate securities; others rely mostly on other types of investments, such as mortgages.

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[1] Data was obtained from the following sources in the order in which it appears on the table:

*Annual Report,* National Association of Mutual Savings Banks, 60 East 42nd St., New York 17, N. Y., May 1960.

Statistical Series—Release No. 1680 of May 31, 1960, Securities and Exchange Commission, Washington, D.C. Includes profit-sharing plans but not health, welfare and bonus plans. It was based on a survey of all corporate pension funds except those administered by insurance companies and unions and funds of non-profit organizations.

A. M. Best and Company, Inc., *Aggregates and Averages, Fire and Casualty,* 1960.

Summary of Governmental Finances in 1959, Dept. of Commerce Publication G-GF 59, August 21, 1960.

Figures from the National Association of Investment Companies, 61 Broadway, New York, N. Y. Excludes "cash" items.

*Assets, Liabilities and Capital Accounts of Commercial and Mutual Savings Banks,* Federal Deposit Insurance Corporation. Figures are approximate because they include some other items. (Report No. 52, Dec. 31, 1959)

### *Supply and Demand for Funds*

While certain types of investors are restricted as to how they can invest their money, there is sufficient fluidity of capital so that funds available for investment will flow to the most attractive media. For this reason, in evaluating who might buy securities and what they might pay, you should have in mind the other broad types of investment that might be available. Your securities not only compete directly with other companies in your industry for investors' attention, but also directly and indirectly with other industries and other types of investments. A brief table on the supply and demand of the principal types in 1959 is shown below.[29] You don't need to study it carefully, but a glance at it will give you an idea of the size of the items.

These figures on the supply side are on a net basis. That is, they are equal to the net increase in holdings by the various investors of the types of assets indicated under uses of funds. The gross flow of funds, which would include funds made available for reinvestment through the repayment of existing loans (amortization payments on mortgages are a prime example) would be equal to about twice the figures shown in the table. Savings and loan associations are a major factor in the supply situation, but not for corporate securities because they invest primarily in mortgages. Investment companies are included in the general category "Individuals and others."

(In billions of dollars)

| *Total Sources (Supply) of Funds* | | *Total Uses (Demand) of Funds* | |
|---|---|---|---|
| Savings institutions | $18.5 | Mortgages | $19.7 |
| Life insurance cos. | 5.2 | Corporate Bonds | 4.0 |
| Savings and loan assoc. | 8.5 | Corporate Stocks | 2.8 |
| Mutual Savings banks | 1.9 | Other Business Credit | 7.0 |
| Corp. Pension funds | 2.9 | State & Local Gov't. Sec. | 5.3 |
| | | U. S. Gov't. Sec. | 8.0 |
| Banking system | 6.2 | Federal Agencies | 2.0 |
| Commercial banks | 5.0 | Consumer Credit | 5.5 |
| Federal Reserve Banks | 1.2 | All Other | 1.4 |
| Government institutions | 4.4 | | |
| State and local funds | 3.3 | | |
| U. S. investment accounts | – 1.0 | | |
| Federal loan agencies | 2.1 | | |
| All other investors | 26.6 | | |
| Corporations | 10.3 | | |
| Fire & cas. ins. cos. | 1.1 | | |
| Foreigners | 3.8 | | |
| Individuals and others | 11.4 | | |
| Total | $55.7 | Total | $55.7 |

On the demand side, the items do not provide for sinking fund and repayment. Note the importance of mortgages. Life insurance companies and other types of investors which can buy mortgages may find them a more attractive media than corporates, particularly when interest rates are low as during a recession.

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[29] From 1959 Record of Life Insurance Investments, page 32, report to the membership of the Life Insurance Association of America, 488 Madison Avenue, New York, N.Y., by James J. O'Leary, Director of Economic Research. Data are estimates made on the basis of preliminary and incomplete data. A negative figure indicates the sale of more investments than purchases.

An approximate breakdown of the purchases of corporate securities by type of investors, as taken from the same source (total sources of funds) as the above table, was as follows:

Corporate Securities Purchased, by Types of Investors[1]
(billions of dollars)

| | *Corp. bonds* | *Corp. stocks* |
|---|---|---|
| Savings institutions: | 2.9 | 1.8 |
| Life insurance cos. | 2.0 | 0.2 |
| Savings and loan assoc. | — | — |
| Mutual savings banks | – 0.1 | 0.1 |
| Corp. pension funds | 1.0 | 1.5 |
| Banking system: | — | — |
| Commercial banks | — | — |
| Federal Reserve Banks | — | — |
| Government institutions: | 1.0 | — |
| State and local funds | 1.0 | — |
| U. S. investment accounts | — | — |
| Federal loan agencies | — | — |
| All other investors: | 0.1 | 1.0 |
| Corporations | — | — |
| Fire & cas. ins. cos. | — | 0.2 |
| Foreigners | — | 0.3 |
| Individuals and others | 0.1 | 0.5 |
| Total | 4.0 | 2.8 |

[1] Where total of any one item is less than $50 million, no figure is shown.

Forecasts of supply and demand figures are used as one clue to the future level of interest rates. However, it is necessary to be very careful in interpreting the figures. It is the slight difference between supply and demand which can have an important effect on interest rates, and it is very difficult to make accurate forecasts of supply and demand. Such figures can only be correctly interpreted for forecasting purposes if there is a thorough understanding of each item included, and a realization that interest rates are affected by other forces as well. These include Federal Reserve policy, the U. S. Government's financial needs, short-term credit demand and, last but not least, the psychological reactions of those who deal in the financial markets.

## THE FEDERAL RESERVE SYSTEM

A Financial Vice President can't expect to be an expert on the daily operations of the Federal Reserve System. It requires the work of an economist following it regularly in order to interpret its actions and resulting effects on business, price levels and interest rates. However, you should have sufficient knowledge to follow an economist's explanation. If you have not had courses in money and banking, you will not completely understand how the Federal Reserve does certain things described below, but this discussion should give you a general idea how the results are obtained.

Perhaps at the start there should be a few words about the organization of the Federal Reserve. There are 12 Federal Reserve Banks located throughout the country. All commercial banks which are members, and this includes most commercial banks with about 85 per cent of total bank deposits, must contribute to the capital of their local Reserve Bank, and they own it. But it is rather a nominal ownership since the return on their stock is limited to 6%, any excess going to the Federal Government after a specified appropriation to surplus. The seven-man Board of Governors in Washington, appointed by the President of the United States, supervises and coordinates the Reserve Banks, and appoints Reserve Bank presidents and three of the nine Reserve Bank directors.

By direction of Congress, which established it, the Federal Reserve System operates for the welfare of our economy. Were you to study its methods of gathering information about our economy through its local Federal Reserve Banks and other media, you would realize that, in so far as humanly possible, it has a very close "feel" of the pulse of our economy.

One of the primary functions of the Federal Reserve System, as it may affect our economy, is its influence over the money supply. As you know, there are two kinds of money: cash and checks. The commercial banking system adds to the money supply by creating bank deposits when the banks add to their assets by making loans, or buying investments like government bonds. However, when a commercial bank increases its deposits, it, in turn, must have a certain percentage of those deposits represented by reserves with the Federal Reserve System. It is this tie which gives the Federal Reserve System its influence over the deposits of the commercial banking system and the money supply. This influence can be exercised in three ways:

1. The Federal Reserve has power within certain limits to vary the percentage of deposits which commercial banks must keep on deposit with the Federal Reserve as reserves.
2. If the commercial banks run out of reserves, they can get additional reserves by temporarily borrowing from the Federal Reserve System. The Federal Reserve can vary the rate it charges on those borrowings and can restrain or encourage such borrowings.
3. Reserves which the commercial banks have on deposit with the Federal Reserve can be increased or decreased through the Federal's open market policy. If the Federal Reserve sells government securities to commercial banks, reserves are reduced as the banks pay for the bonds. If it buys governments from commercial banks, reserves are increased. The New York Reserve Bank carries out principal money market transactions.

When there is a recession, the Federal Reserve tends to loosen the reins, make money easy and cheap to borrow. On the other hand, when business is booming and there is a threat of inflation, the Federal Reserve tries to keep the reigns tight, and through holding back on reserves, it can make money more difficult and costly to borrow. In connection with commercial banks borrowing from the Federal Reserve, there seems to be one general misconception. Commercial banks cannot freely use the Federal Reserve as a source of funds. The Federal Reserve frowns on a commercial bank being indebted to it except for a short period of time. It will use pressure to see that such indebtedness does not occur. Commercial banks will have to adjust their business in order to prevent themselves from getting in that spot.

Officials of the Federal Reserve System would be the first to deny that they can control the economy through their actions. All they can do is assist and encourage our economy in the right direction through their positive or negative effect on the availability of bank funds, and thus on interest rates established by the over-all demand and supply of funds for investment.

You may wonder how the control over the commercial bank reserves affects the interest on long-term corporate securities. The rate of interest results from a chain of reactions in the money supply. The general idea is as follows. If the Federal Reserve takes action to add to the supply of money and reduce interest rates, the first affected will be the commercial banks. They will have more funds available. In seeking to keep them invested they will buy short-term governments, and this added demand will reduce the rate on them. This, in turn, will make the higher rate on longer governments more attractive, and banks and other investors will then purchase the longer ones. As a further step, investors who have been buying long-term governments because of their previous attractive interest yield will be forced to seek other more interesting investments as the yield on governments decreases. They will turn to corporate bonds, and so the chain goes on. When interest rates are tightened, the chain reaction works in reverse. Actually, the market in long-term securities may not await the chain reaction; it may anticipate the expected result.

As far as the subject of this book is concerned, the Financial Vice President will be primarily concerned with the way the Federal Reserve System may affect interest rates, and hence the rate at which long-term debt can be sold. Interest rates also may have an effect on yields on high grade preferred stocks. And the effect of the action of the Federal Reserve on business may carry through to the common stock market. As pointed out in other parts of the book, financing plans should not be based on an assumption that interest rates and stock market can be forecast with any degree of accuracy, but the problem cannot entirely be ignored. So you will wish to be able to follow experts when they talk about it.

This brief description may not be enough to satisfy you. There is no need to include more in this book on the subject. The main purpose of this section is to jog your thinking to see if you might need some more work in the field. If you wish to pursue this subject further, the Federal Reserve will furnish you with excellent reading material. Write to the Federal Reserve Bank of New York, 33 Liberty Street, New York City for a hundred-page booklet, *Federal Reserve Operations in the Money and Government Securities Markets* (free) by Robert V. Roosa; *The Money Side of the Street* (70¢) by Dr. Carl H. Madden, Manager of the Public Information Department; and *The Federal Reserve System—Purposes and Functions* (free), Board of Governors of the Federal Reserve System. And if you are interested in following the money market operations of the Federal Reserve, your best bet is to have your name added to the mailing list for the *Monthly Review* of the Federal Reserve Bank of New York.

## GOVERNMENT REGULATION

The unethical and unsound financial practices which occurred in the late 1920's became glaringly evident during the great depression in the early 1930's. As a necessary result, Congress decided that it was in the general public interest that the investor be protected. The Securities Act of 1933 was passed and the Securities and Exchange Commission was set up to administer it.[30]

After the Act was first passed, the howls in Wall Street could be heard far and wide: "We can't do business under the Act, the penalties are too great." "There will be no more underwriting of securities." "The Government is crucifying Wall Street and blocking the flow of capital."

After a while some brave souls started to function under the Act, and then others followed. Now most people in Wall Street will say that the idea of the Act is sound. There must be some regulation since the average individual investor is not sufficiently knowledgeable to protect himself against the unscrupulous financial operator. Naturally, with all the money involved in finance, there are unscrupulous men in the industry. They are best able to operate during a bull stock market when the small investors, hoping for quick profits, buy on tips. The Securities and Exchange Commission has a tough job on its hands to ferret them out and also to prosecute them. Handling of other people's money should be done on the basis of the highest trust and with expert knowledge; these attributes combined, in their highest sense, are not easy to come by.

You cannot sell securities today without knowing about the Securities Act of 1933. It covers the distribution of securities. Since it is a Federal law, it pertains to securities sold through the mails or in interstate commerce. Certain securities are exempt from registration though not from the fraud provisions. One broad group of exempt corporate securities are those of the railroads.[31] The companies issuing these securities are regulated by the Interstate Commerce Commission; so, when the Act was passed, it was felt unnecessary to include them.

A basic purpose of the Act is to make certain that a company, when selling a new issue, gives full and fair disclosure of all the facts necessary for a potential purchaser to make a proper evaluation. The Act is for the purpose of preventing the issuance of misleading information or the withholding of material information in connection with the distribution of securities.

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[30] The Securities Act of 1933 was originally administered by the Federal Trade Commission. Congress passed the Securities Exchange Act a year later and created the Securities and Exchange Commission to administer both acts.

[31] Securities Act of 1933, Section 3 (a) (6).

Unless a security or transaction is exempt, a company must file a registration statement with the Securities and Exchange Commission prior to the public offering. Offers to sell a new security must be accompanied by a prospectus which includes most of the information filed in the registration statement. Although there are registration forms and prospectuses for many types of issues and offerings, there are two types commonly used by industrial, commercial and utility companies. The form S-9, which is a simplified form, can be used for bonds of companies meeting certain standards; the longer form, S-1, has more general application.

A registration statement becomes effective automatically 20 days after filing unless the SEC grants an acceleration.[32] Each amendment filed before the effective date automatically starts a new twenty-day period running from the date of the amendment. Acceleration of the 20-day period from the time of original filing is unusual, but more readily applies to the time applicable to amendments. As soon as the registration statement becomes effective, sales of the security can begin.

A company must be careful about what information it gives out while financing is in process, or it might be suspected of trying to sell its securities without using a prospectus. Also, it is important for a company to consider how an offering affects its general program to keep its existing investors fully informed during the period.

The Act starts to apply when a company expects to offer securities. When this occurs is a matter of judgment in many instances. From this starting date, until the registration statement is filed, dissemination of information for purposes of financing is limited to that provided by the company to the underwriters. There is no restriction at any time as to the type of information for this purpose.

When the registration statement is filed and until it is effective, there will be available a preliminary or so-called "red herring" prospectus.[33] At this point, the underwriters may distribute this prospectus to investors and dealers, but no other written sales material may be provided by the company or underwriters. Offers to purchase the securities may be made by dealers and investors during this period, but such offers cannot be accepted by the underwriters until the statement has become effective. The underwriters cannot sign up selected dealers, but they can find out which ones will be interested in handling the issue and make all arrangements for signing them up as soon as the registration statement becomes effective.

When the registration statement becomes effective with all amendments, all offers to sell must be accompanied by a final so-called offering prospectus.[34] Now, other written material supplementary to the prospectus may be used with the prospectus, but from the point of view of the company, it would be preferable that the prospectus include all pertinent information, and the prospectus should be written as the basic sales document.

The Act continues to apply as respects the material that can be given out by the company, until all the issue is sold by underwriters and dealers. There is a statement sometimes made to the effect that the period continues until 40 days after the day on which the issue was offered publicly if all of the security has been sold in a shorter period. However, the section in the Act in which the 40 days is mentioned applies to dealers and underwriters, and not to the company.

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[32] As a practical matter, a company would not wish to offer a security until the SEC has had an opportunity to review the registration statement. Therefore, the work load of the SEC may affect the time schedule of an offering.

[33] There is a similar form of prospectus used by the underwriters' group, known as the "participating underwriters prospectus." There is still another form known as a summary prospectus which may be used for certain purposes. It applies to both the preliminary and final forms.

[34] There is a type of prospectus, which comes into play in a competitive bidding, known as the bidding prospectus. It is the same as a final prospectus and is used for bidding purposes, but does not include the price, call prices, etc., which can only be filled in after the bidding has taken place. It is final in all respects, except for these items.

Although the statute does not attempt to govern the nature of negotiations between issuers and underwriters on the subjects which may be discussed in such negotiations, the information used in the public sale of a security must be limited to facts. Anything of a "puffing" nature is obviously not permitted. The Securities and Exchange Commission has taken the approach that forecast earnings are not matters which can properly be included in a registration statement and prospectus. This is the general area in which a company should take care. Also, if the company should give out such information to potential purchasers during an offering, it may be stopped and the company penalized. If an underwriter commits such an error, it too might be penalized or, in the alternative, might have to withdraw from the underwriting group.

The above comments are important to a company in evaluating the extent to which a so-called "sales campaign" can be developed in a negotiated public offering during the period prior to the effective date. In this connection, it may be noted that the protective provisions of the Act are intended to operate for the benefit of the dealers as well as the investors.

In carrying out its regular investor relations program, a question may arise as to what type of information a company can give out during an offering of securities. Things of a routine nature, such as quarterly and annual reports which have been issued regularly without regard to financing, are, under ordinary circumstances, permissible. Of course, care must be taken not to include information which might suggest that it is in fact part of the program to sell the securities.

As a practical matter, a company need not worry about the penalties under the Act, even though they are severe, if, in good conscience, it does its best to carry out the principles of the Act. The philosophy behind the Act is essential for the protection of capital, and thus of our economy. For the most part, the Securities and Exchange Commission has done a realistic job in administering the Act.

A company must rely on counsel familiar with the Act in complying with its provisions, or in determining whether a transaction is exempt. Too technical a lawyer can make the Act appear unnecessarily burdensome.

Many of the costs incurred in the public sale of a security, other than the underwriting discount, taxes and engraving, are a result of the Act. The printing business has benefited materially.

Other important Federal legislation, which was passed at about the same time as the Securities Act, was the Securities Exchange Act of 1934 and the Trust Indenture Act of 1939. The former covers trading in securities and governs such matters as exchange operations, margin requirements, full disclosure for listed securities, buying and selling by insiders, and the procedure that must be followed in a short sale in order to prevent bear raids, broker-dealer relationship with customers, proxies, etc. The Trust Indenture Act supplements the Securities Act of 1933 and establishes certain provisions which must be included in the indentures for large, publicly-offered debt issues. This aspect was referred to in the last chapter on types of securities.

Most states have some law regulating the sale of securities. When a new issue is offered, the term "Blue Sky" is often used. It refers to making the necessary filings in the states where the security will be sold in order to comply with the state laws. The term "Blue Sky" to denote state security laws arose many years before the Securities Act, when the states were struggling with the prevention of the sale of fraudulent securities. The statement was made, in the discussion of the subject in a state legislature, that security dealers would try to sell you the blue sky. So state laws were passed to prevent frauds, and that term became attached to such state laws. Large high-grade issues can be processed rather easily through the state securities commissions, but a complicated type of issue may take time. It is essential that it be completed in time for the sale; otherwise the securities cannot be offered in the state. The states have exclusive jurisdiction over the intrastate security sales which do not use the mails or means of interstate commerce. Processing of applications for compliance with Blue Sky Laws is the job of the lawyers for the underwriters.

## ASSOCIATIONS OF FINANCIAL ORGANIZATIONS

In your dealing with the financial community, you will run across a number of different associations. You may have occasion to know what they represent. We will finish this chapter by describing some of the most important ones and some possible reasons why the Financial Vice President might be interested in them. They are given in alphabetical order. Many financial organizations and their representatives may be members in more than one of the associations if they are engaged in various phases of finance.

### *The Association of Stock Exchange Firms*[35]

This organization includes the majority of firms which are members of the New York Stock Exchange. The Exchange itself carries on certain functions for the member firms and the Association is, in effect, a supplementary working organization. As far as corporate executives are concerned, there is relatively little contact with the Association except in very special circumstances. There is a similar group composed of member firms on the Midwest Stock Exchange in Chicago. The New York Association has five groups affiliated with it, composed of people who are working in various capacities in the operations of the firms themselves, such as cashiers, accountants and so forth. Such meetings as are held by the Association and its affiliated senior employee divisions are normally confined to their respective memberships and would not include corporate executives.

Perhaps one point of interest is the fact that companies, in connection with their proxy work, contact the cashiers and their assistants in the Stock Exchange firms. A company might wish to obtain a list of the cashiers through the directory of that group.

As far as Stock Exchange firms are concerned, you will be primarily interested in those firms which are interested in your company. The specialist in your stock on the floor of the exchanges where you are listed can tell you which they are. If you are listed on an exchange, you will want to know your specialist personally. He can help you understand the market for your stock, and he will be interested to have you keep him informed about your company.

### *The Bond Club of New York*

This organization is composed of a group of people in the investment, security or banking business, and its membership includes about 750 people who are actively engaged in these businesses. It holds a series of luncheon meetings, an annual dinner, and a yearly Field Day at a suburban country club. As an outsider, you would not have any direct interest in the Club, but you might wish to arrange to get hold of a copy of the annual publication, entitled *The Bawl Street Journal.* It comes out each year at the time of the outing and is a very spicy, no-holds-barred take-off on the financial community. It costs $1.00 per copy. Have your friends in the Street send you a copy. It will provide you with some enjoyable light reading.

### *The Investment Bankers Association of America*[36]

This is a national association with eighteen regional groups, and it includes firms engaged in some phase of underwriting various types of security. There are 804 member firms. Many firms do other types of financial business, such as functioning as a broker, dealer or investment advisor. The annual national convention is a big one, with an attendance of about 1200 individuals. It is held in Florida and lasts for about a week at the end of November or early December. If you plan to visit the financial community to see investment banking firms at that time, you may find that many of the seniors will be away at the convention. Companies wishing to find out which firms are members can determine this by consulting the Blue Book of the Association.

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[35] Address: 120 Broadway, New York 5, N. Y.

[36] Address: 425 13th Street, NW, Washington, D. C.

### *The Life Insurance Association of America*[37]

This organization carries out a number of studies of investment operations of life insurance companies. If you are a large company and have senior securities outstanding, undoubtedly some of them are held by life insurance companies. The New York office issues an annual report which gives much financial information on the life insurance company investments. It has a senior economist and an investment research staff, and makes a number of special studies relating to investments. This includes some general economic data, such as sources and uses of funds referred to in this chapter.

There is another separate organization, The Institute of Life Insurance,[38] which issues a fact book each year which gives statistics on investments of these companies. Occasionally, the Institute does a public relations type of survey on life insurance investments. It has a public relations office which serves as a central source of information about life insurance in general. It may be helpful in directing your inquiry to a proper source of information.

A book (previously mentioned) entitled *Corporate Holdings of Insurance Companies*, compiled by the United Statistical Associates, Incorporated, lists all investments of life insurance and other types of insurance companies. So, if your bonds are not registered, here is where you can find out which insurance companies own your securities.

### *The National Association of Investors' Brokers*

This organization was founded in 1950 to bring together organizations of registered representatives from various cities throughout the country. The name "registered representative" is the designation applied by the New York Stock Exchange to men and women employed by member firms who have met the Exchange's requirements for soliciting and handling securities business from the public. Local organizations of the NAIB are known by various names. In New York it is the Association of Customers' Brokers[39]—this was the first organization of its kind, founded in 1939, and it had approximately 1,300 members enrolled in 1960. Of these, 125 were Associate Members, a classification for those who have become partners or officers in Exchange firms. The ACB consists principally of men and women who advise and service commission brokerage accounts. Educational meetings (occasionally corporate executives are speakers) of the Association are held frequently, and business and social meetings are scheduled quarterly. The chapter of NAIB in Chicago is called "Stock Brokers' Associates." Other groups have been formed in Detroit, Los Angeles, San Francisco, Seattle, Philadelphia and Washington, D.C.

### *The National Association of Investment Companies*[40]

This organization includes companies with over 95% of the assets of all open-end investment companies and a large majority of the diversified, publicly-held, closed-end investment companies. These companies have become so important as owners of large amounts of common stocks and for directing the flow of capital that not to know something about them is to stick your head in the sand. The Association maintains lists of investment companies, which can be referred to. Sources of portfolio information are available:

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[37] Address: 488 Madison Avenue, New York 22, N. Y.

[38] Address: 488 Madison Avenue, New York 22, N. Y.

[39] Address: 120 Broadway, New York 5, N. Y.

[40] Address: 61 Broadway, New York 6, N. Y.

> Henry Ansbacher Long prepares quarterly reports on changes in investments in *Barron's National Business and Financial Weekly*, (Barron's Publications, 50 Broadway, New York 6, N. Y.). These are also available in reprint form from about two dozen major NYSE firms.
>
> Vickers Associates, Inc., (48 Elm Street, Huntington, N. Y.) in their *Guide To Investment Company Portfolios* compile the holdings of all the investment companies in the United States and Canada annually, and compile the buying and selling of the investment companies quarterly. *Vickers' Favorite 50,* issued quarterly, is a part of this service, which ranks by dollar value the fifty stocks most popular with investment companies. Annual subscription to the *Guide* is $110.00. A special Service for corporations shows the holdings and quarterly changes by investment companies of the corporation's stock. Fee for this depends upon the number of investment companies holding the stock, but would range between $40 and $50 per year. Special industry group reports of investment company holdings, covering a period up to 20 years, are available on a fee basis.
>
> A book, published each year by Arthur Wiesenberger (61 Broadway, New York 6, N. Y.), *Investment Companies,* price $25, gives the investments of all principal funds.

There is one thing you should know about the investment company's business or you will be quite confused. A number of investment companies may be sponsored and managed by one organization which provides all the investment advice for its group of associated companies. You will need to make only one contact for all the associated companies, and the organization you will wish to see is the one which sponsors them. For example, Lord Abbett & Co. manages two investment companies; Investors Diversified Services, Inc., runs five. There are also some funds which, although managed individually, have the same officers and research staff, such as Massachusetts Investors Trust, along with its affiliated company, Massachusetts Investors Growth Stock Fund, Inc.

*The Investment Dealers' Digest,*[41] on its own, sponsors each year a conference of mutual fund dealers. Corporations sometimes make a point of appearing at this convention.

### *National Association of Mutual Savings Banks*[42]

This is an association of mutual savings banks throughout the country. It has a well-staffed office in New York which can give up-to-date information about the over-all investments of these banks. It issues an annual report including such information. The importance of the savings banks varies throughout the country, with New York being the state of major importance. In New York State there is a central bank for all the local banks: The Savings Bank Trust Company, 14 Wall Street. This bank provides investment recommendations for the banks throughout the state.

### *The National Association of Securities Dealers, Inc.*[43]

This organization has 4,086 member firms, from the big to the little dealer. Its members comprise the group who will actually be making the market in your securities if they are over-the-counter. They also may be involved in the sale of your new security issues as members of the group of selected dealers, whether or not you are listed. You ought to keep them in mind as part of your investor relations program. You should know what makes them click and how to keep them interested in your securities. At least, by having someone take a peek at the "Pink Sheets," previously referred to in this chapter, you should know who are the principal firms trading in your securities. If you are not listed on an exchange and wish to have your securities quoted in the over-the-counter section of the principal newspapers, you will have to apply to a committee of this organization.

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[41] The Dealers' Digest Publishing Co., 150 Broadway, New York 38, N. Y.

[42] Address: Executive Vice President, 60 East 42 Street, New York 17, N. Y.

[43] Address: Executive Director, 1707 H Street, NW, Washington 6, D. C.

Some firms act as dealers and also as brokers, being members of an exchange as well. The men in dealer firms who contact the investors are known as registered representatives, the same term used for men in a similar position in brokerage firms.

### *The National Federation of Financial Analysts Societies*

This organization consists of twenty-three sister societies located in various parts of the United States, and one in Toronto and one in Montreal. There are 6,300 individual members with varying interests in different types of securities. They hold an annual convention in the spring at which many companies make it a point to be represented, so that the analyst can be contacted. The analysts welcome participation. There is an annual *Directory of Members* each year, which can be purchased for $6.25 per copy through the treasurer of the National Federation or any of the local societies.

The largest society and one which meets the most often is the New York Society of Security Analysts.[44] It has about 2500 members interested in various types of security analysis. It meets every weekday at luncheon, at which times the president or principal financial officer of some company presents his story. Attendance will vary from about 100 to 300, depending on the type of company. The Society also holds occasional dinner meetings at its headquarters for its members and guests. At these meetings some of the leading corporations may be asked to cover special topics.

If you are a large company, you should certainly appear on their regular program. The operations of the other societies varies considerably as to type of members and frequency of meeting. Enough has been said here on this subject, because it is covered in more detail in Chapter IX on investor relations.

### *The New York Financial Writer's Association, Inc.*[45]

This organization numbers 125 active members of the working press and 108 associate members who are former active members. They are the reporters and financial editors of financial magazines and newspapers. The membership of the association also includes financial writers for the leading wire services, and for news and feature syndicates. Financial news from such sources, of course, appears not only in printed publications throughout the world but also is used by other mass media of communication, such as radio and television.

The Association has a big dinner and show once a year called the Financial Follies. It is put on by the writers themselves and is a take-off on things that happened during the year. It is by invitation only. If a company is lucky enough to be invited, it represents a fine opportunity to renew acquaintances with the people who will be writing about your company; besides, it is a lot of fun. Of course, if your company is of a sufficient size to be of interest financially on a national scale, you will want to maintain a regular and close relationship with the principal financial writers.

### *Pension Funds Association*

Pension Funds as yet have no formal group which has meetings at which a company interested in actual or potential purchasers of its securities might attend. However, there is a trade association known as The American Pension Conference made up of companies, banks, insurance companies, actuaries and lawyers who have or administer pension funds. It holds bi-monthly meetings in New York. There is a similar group on the West Coast.

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[44] Address: New York Society of Security Analysts, 15 William St., New York 5, New York. Meetings are held at 15 William Street.

[45] Address: Executive Secretary, Box 382, Grand Central Station, New York 17, New York.

*CHAPTER VII*

# Selling Senior Securities

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At this point it has been decided that our company needs to raise capital by the sale of some form of senior securities—bonds, debentures, notes or preferred stock. We will assume that the tentative terms acceptable for the new securities have already been outlined. The decision has been made to sell the securities now, and we are faced with that job. This chapter tells how to handle the three major questions with which you will be concerned:

The method of sale;
The offering price;
The amount of the financing costs.

We will start off with a statement about the goal that is to be achieved, so that we will be sure of our aim. In case you are not thoroughly familiar with financing, we will cover next what is meant by the price of a senior security and the items of financing costs. As further preliminary information, we will define briefly the methods that may be used in selling senior securities and show the extent of their use by corporations.

With the above outline as background, we will get into a more comprehensive look at the methods of financing. We will give you two complete examples of methods of offering securities. They will take you behind the scenes so that you will know what the parties actually do, step by step. These examples will give you the detail you need in order to obtain a real feeling of the subject, and they will assist you in evaluating the application of each method of financing and the advantages and disadvantages of each.

You will need to know how to establish the price of a new security offering in order to be able to negotiate with underwriters or ultimate purchasers. Any financing involves a knowledge of financing costs, their possible magnitude and all the factors which may affect them. These matters are given careful attention. Then the chapter concludes with two subjects which are closely related to senior security financing: refunding and exchange offers.

Selling common stock is dealt with in the next chapter. Because common stock may be offered through rights to existing common stockholders, there are special techniques required, and for other reasons as well, selling common stock is more complicated. The present chapter will give a good background for the one to follow.

Since convertibles, either bonds or preferred, contain some elements of common stock, selling them is also covered in the next chapter. There have been some senior securities sold to existing security holders. This practice is so limited that it is not given special attention. However, the material in this and the next chapter will help you handle such a situation.

## THE GOAL IN SELLING SENIOR SECURITIES

What are we going to try to accomplish? The ultimate aim in selling a senior security is to obtain the most satisfactory price and terms at the least selling cost commensurate with the sales job to be done. The selling costs refer to all costs involved in the financing. In other words, the goal is to hire money at the least selling cost and at the best price and terms.

By satisfactory price is generally meant the highest price. When a company offers stock or a convertible issue to its own common stockholders, the meaning of the most satisfactory price will include making the offer attractive so that the owners will be happy. Even when common stock is sold directly to the public, rather than to its own stockholders, there is a school of thought that it should be priced so that the buyers will get a good buy. The advocates of this school contend that satisfied security buyers make it easier to sell future issues. They say: buyers who get burned aren't so eager the next time the company comes to the market. However, this problem pertains primarily to common stocks, which will be discussed in the next chapter. Senior securities, such as bonds, are sold mostly to the sophisticated or informed buyers who know their way around and buy only if the price is right. Therefore, our original statement does mean obtaining the highest price for senior securities.

To illustrate, suppose a bond is offered for 100 and then shortly after the sale, it is traded in the market at 97, even though there has been no change in security markets. Naturally a buyer wouldn't be happy even if he bought it with his eyes open. However, suppose the price went up to 103, then the shoe is on the other foot. The company might have reason to complain that the offering price was too low and it "got took." Certainly, if good grade senior securities are sold to sophisticated buyers, it doesn't look well for a company when the price jumps to more than a small premium, say, one point or less, after the sale is completed, in normal market conditions.

The price of a security may be affected by the terms. Under certain circumstances, it may be worthwhile to accept a lower price in order to avoid too restrictive terms. A company, by concentrating on the price alone, may feel that it is doing a great job of saving ⅛ of 1% in the rate on a senior security, whereas in reality it may accept terms which will prove to be far more costly, in one way or another, at some time in the future. The terms are usually difficult to analyze, and some take effect so far in the future that they get brushed aside. As was stressed in Chapter V, "Types of Securities," the terms should be looked upon as part of the price.

After the statement "the least selling cost," was added "commensurate with the sales job to be done." In the sale of certain securities, much sales effort may be necessary, and in order to obtain the best price and terms, paying a higher selling cost may produce a better over-all result. Furthermore, in certain instances, it may be advantageous to have the underwriters perform some functions connected with the sale other than just underwriting. Thus, "the least selling cost" should imply that cost commensurate with the most satisfactory performance toward achievement of the objectives sought in a particular offering. However, it is mostly in common stock financing that the underwriters may have some special task to perform, as we will see in the next chapter. Therefore, since we are now offering senior securities, which are largely sold to sophisticated institutional purchasers, we can still limit the goal as it was originally stated: to obtain the best price or rate and terms at the least selling cost.

## WHAT ARE PRICE AND COST?

We have already talked in general about prices of securities and costs involved in a new issue. In this chapter, they are the principal elements in our goal. If you know what is meant by yield to maturity, cost of financing, the difference between proceeds to company and net proceeds to company, etc., you can skip what comes under this heading. But if there is any question in your mind, it will be worthwhile for you to read it. You will need to have a precise understanding of these terms.

The first complete example which we shall use in explaining how to sell securities will be an offering by Consolidated Edison Company of New York, Inc., of $50,000,000 principal amount of mortgage bonds with an interest coupon of 4% and a 30-year maturity. We will use this offering now to define terms. Here are the figures from that sale in both percentage of principal amount and total amount.

| *Item* | *Percentage of Principal Amount* | *Total Amount* |
|---|---|---|
| 1. Price to Public | 102.6550% | $51,327,500 |
| 2. Underwriters' Compensation | 0.6151 | 307,550 |
| 3. Proceeds to Company | 102.0399 | $51,019,950 |
| 4. Expenses | 0.8654 | 432,700 |
| 5. Net Proceeds to Company | 101.1745 | $50,587,250 |

Although these terms are probably obvious, they are explained as follows:

> *Price to public* is the price at which the underwriters sold the bonds to purchasers or investors. It is sometimes referred to as the list price or original offering price.
>
> *Underwriters' compensation* is the gross amount the underwriters obtained for their efforts. This is also referred to as fee, commission, or spread. In a prospectus, it is called underwriting discounts and commissions. The terms "spread" and "discount" are most in conformity with the idea that the underwriters, acting as principals, buy an issue, take title and sell it at an increased price. The term "commission" is more nearly associated with a broker who acts as agent. Throughout the book, we will generally use the terms "spread," "discount," or "compensation" for the amount the underwriters receive, when they act in their capacity as underwriters. As will be discussed subsequently, the amount must cover the underwriting risk, the managing underwriters' fee, discounts allowed to participating dealers, legal expenses (in most cases), etc. When

an investment banker acts as an agent in a private sale, we will use the term "fee" for his compensation.

*Proceeds to company* is the amount the underwriters paid the company for the bonds. It is the price they bid for the issue. It is referred to as the "bid price" or "price to the company."

*Expenses* are the total cash outlays the company incurred in connection with the financing. As will be discussed subsequently, these are the outside expenses for the registration statement, auditors' fees, fees to outside experts, etc., They do not includes the wages and salaries of the company's own staff who worked on the financing.

*Net proceeds to company* is the amount of funds the company received from the financing after all outside costs were deducted.

*Cost of financing,* or *financing costs,* a term not shown above, is used to express the total cash costs for selling securities. It is a total of the two items "underwriters' compensation" and "expenses." It is the cash cost to get the money to the company from the investors. The Securities and Exchange Commission uses the term "cost of flotation," but it means the same thing. The idea of "cash costs" is stressed, because as will be seen later on, there are some other items of non-cash nature which may have to be evaluated in a security offering.

The financing costs are, thus, a total of items 2 and 4:

| | *Percentage of Principal Amount* | *Total Amount* |
|---|---|---|
| 2. Underwriters' Compensation | 0.6151% | $ 307,550 |
| 4. Expenses | 0.8654 | 432,700 |
| Financing Costs | 1.4805 | $ 740,250 |

Or (next table), it is the difference between items 1 and 5.

We haven't yet arrived at the real "price" of the bond. That is expressed as a yield to maturity.

| | *Percentage of Principal Amount* | *Total Amount* |
|---|---|---|
| 1. Price to Public | 102.6550% | $51,327,500 |
| Less: | | |
| 5. Net Proceeds to Company | 101.1745 | 50,587,250 |
| Financing Costs | 1.4805 | $ 740,250 |

When an investor bought one of the bonds, he paid a price of 102.655. If the bond had a denomination of $100 principal amount, the price the investor would pay per bond would be $102.655; if the denomination were $1,000 principal amount, the price per bond would be $1,026.55. He would receive interest at the rate of 4% per year, and in 30 years he would be repaid 100% of the principal amount by the company.

If he holds the bond to maturity, he will gain, for each $100 principal amount, $4.00 in interest per year, but he will lose $2.655, that is, the premium price he paid over the $100 of principal amount he gets at maturity. So, the effective yield is a combination of the interest he gains each year and the premium he loses, which must be written off over the 30-year maturity of the bonds. The result is the yield to maturity. This can be calculated by means of a complicated compound interest formula, but there is no need for that. It has all been done for you in tables compiled in Bond Value Tables. Some Bond Value Tables give prices for each 0.01% of yield, others for each 0.05%. An excerpt, to fit our example, from a book[1] with prices for each 0.05% is shown below.

4% INTEREST COUPON

| *Yield* | *Maturity* 29½ *yrs.* | 30 *yrs.* | 30½ *yrs.* |
|---|---|---|---|
| 3.80 | 103.53 | 103.56 | 103.59 |
| *3.85* | 102.63 | *102.66* | 102.68 |
| 3.90 | 101.74 | 101.76 | 101.77 |
| 3.95 | 100.87 | 100.87 | 100.88 |
| 4.00 | 100.00 | 100.00 | 100.00 |
| 4.05 | 99.14 | 99.14 | 99.13 |

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[1] *Comprehensive Bond Value Tables,* published by Financial Publishing Company, 82 Brookline Ave., Boston 13, Massachusetts.

The lefthand column gives us the yield to maturity which we are after. We find the yield for our bond by first looking for the price of 102.66 in the column marked 30 years, which is for bonds with that maturity. We then look for the yield opposite that price[2] in the lefthand column; this gives us the 3.85%.

If a bond sells below 100, then the purchaser, in addition to the interest, gains the difference between the price he paid and 100, which he gets at maturity. The yield to maturity, which would be higher than the interest coupon, is found in the same manner by reference to Bond Value Tables.

The items which were shown above for our bond offering can be expressed in terms of yield to maturity, as shown below. The dollar figures are rounded to the third decimal place, which is as far out as they need be carried in order to calculate an approximate yield.

| *Item* | *Percentage of Principal Amount* | *Yield to Maturity* |
|---|---|---|
| 1. Price to public | 102.655 | 3.85% |
| 2. Underwriters' Compensation | 0.615 | |
| 3. Proceeds to Company | 102.040 | 3.88% |
| 4. Expenses | 0.865 | |
| 5. Net proceeds to Company | 101.175 | 3.92% |

These are a lot of figures on one point if you are not familiar with the subject; so let's summarize them: The underwriters figured that they could sell the bonds to the public at 102.655 to yield 3.85%. They decided that their compensation should be 0.615; so they bid approximately 102.040, which was the proceeds the company received. The yield at the bid price is 3.88%. The company's expenses were 0.865, resulting in a net proceeds to the company of 101.175, making a cost of money to the company of 3.92%. The financing costs were 1.481, which was a total of the underwriters' compensation of 0.615, equivalent to 0.03% in terms of yield, and the expenses of 0.865, equivalent to 0.04% in terms of yield. The expenses were high for this type of an issue because of the New York State Mortgage tax.

A term which you will continually hear in reference to yields is "basis point." It is well that you know what it means. It is sometimes erroneously referred to as bases point. Anyway, it is very simple: it is 1/100 of 1% yield or, in other words, 0.01% yield. For example, 5 basis points would be 0.05% yield to maturity. One very rough rule of thumb to quickly translate price into yield is that $1 in the price of a bond per $100 principal amount is equivalent to about 5 basis points in yield. This rough rule should be used with caution. It varies with interest rate on the bonds, the price and particularly with the maturity. It does not apply at all to bonds with short maturities. An idea of how it varies with maturity can be gathered from the figures given on the next page, taken from Bond Value Tables.

Thus, for the longer maturities, a difference in yield of 0.05%, or 5 basis points, is approximately equivalent to a difference of about $1 in the price of a bond for each $100 principal amount, but this relationship doesn't hold as the maturity shortens.

Since this chapter also deals with preferred stocks, we should point out that the terms used above for bonds generally apply in the same way to preferreds. However, prices and other items are expressed in dollars per share, and since a preferred stock has no maturity,[3] the yield is obtained merely by dividing the price into the dividend rate. This is what is called a current yield, as contrasted with a yield to maturity on a bond.

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[2] If no price in the column corresponds to the price of our bonds, it is necessary to interpolate between the nearest two prices. Similarly, if the maturity does not exactly correspond, it is necessary to interpolate. Interpolation is accomplished by a simple matter of ratio and proportions. When there is a serial maturity or sinking fund the problem is more complicated, and it is first necessary to calculate the weighted average maturity. Interpolation is satisfactory for most purposes, but it is not entirely accurate, since the differences between the figures given in the Bond Value Tables are not on a straight line basis. If extreme accuracy is required, it may be best to have the yield calculated by the Financial Publishing Company, referred to in the previous footnote. They have a competent staff of actuaries to handle such problems, and their charge is nominal.

BASIS POINTS ILLUSTRATION

| | | Maturity | | | | |
|---|---|---|---|---|---|---|
| | *Yield* | *10 yrs.* | *20 yrs.* | *30 yrs.* | *40 yrs.* | *50 yrs.* |
| 4% Interest Coupon | | | | | | |
| | 3.95% | 100.41 | 100.69 | 100.87 | 101.00 | 101.09 |
| | 4.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| 5 Basis Points | 0.05% | 0.41 | 0.69 | 0.87 | 1.00 | 1.09 |

So, while we can and do talk of the price of a bond and preferred stock, in itself it is meaningless, unless for a bond it is related to the interest rate and maturity to obtain the yield to maturity, and for a preferred stock it is related to the dividend to obtain the current yield. The price and yield move in opposite directions: a high price means a low yield, and a low price, a high yield.

## METHODS OF SALE

The methods of sale of senior securities can be classified under three headings:

Competitive Public Offering;
Negotiated Public Offering;
Private Sale.

A few brief words about these methods: The first two involve public offerings and require registration under the Securities Act, with certain exceptions. The underwriters purchase the securities as principals and then sell them to investors. In a competitive sale, the price is determined by competitive bidding; the underwriters bid for the issue and the award is made to the highest bidder.[4]

In a negotiated sale, an underwriting group negotiates with the company as to the price at which it buys the issue from the company.

In a private sale, one of the characteristics is that the securities are sold through negotiation directly to investors without any underwriting, although an investment banker may help the company by acting as an agent. Private sale eliminates the necessity of registering with the Securities and Exchange Commission, but in order to be exempt under the Securities Act a private sale must meet certain tests.

In some offerings, it may be possible to use any one of the three methods; so you may have to make a choice. If, for example, an issue could be sold competitively, it could also be sold by means of a negotiated public offering, provided no regulation required competitive bidding. Depending on the type and number of buyers involved, it could probably be sold at private sale. Such a situation may present a nice problem to determine which is best for the issuing company. Before we discuss each method more fully, let's take a look at the extent to which each is used for corporate financing.

### *Extent of Use of Methods of Sale*

The type of industry has an important bearing on the method adopted. This is about the picture for senior securities:

> Debt securities in the railroad[5] and utility fields[6] are predominantly sold competi-

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[3] If a preferred stock has a sinking fund, then elements similar to those of a bond with a sinking fund are present as far as yield is concerned. The yield would have to take into account the average length of life of the issue.

[4] There have been instances in which investors entered bids either directly or through agents in competitive offerings, but these are very rare exceptions and can be disregarded for purposes of this book.

[5] In 1926, the Interstate Commerce Commission ruled that, with certain exceptions, railroads must sell equipment trust certificates at competitive bidding. And as a result of a study in 1943, the Commission established that competitive bidding should be used for practically all railroad debt financing.

[6] In the utility field, the companies which are subject

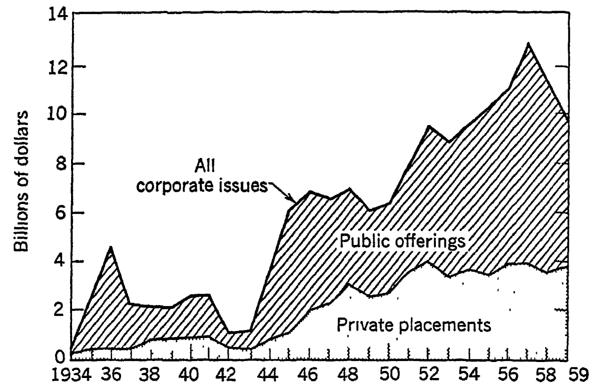
tively. This has been a result largely of regulatory action with which these industries must comply. Some utilities, not forced to do so by state or federal statute or ruling, use competitive bidding by choice. In the utility field, when competitive bidding is not used, the method is either negotiated public sale or private sale.

In the industrial field, competitive bidding is practically unknown for any type of security. A greater number of debt securities of industrial companies are offered privately than by negotiated public sale.

For preferred stocks the picture in general is the same. Competitive bidding is limited to the fields where companies are regulated. Negotiated public offering and private sale are used to some extent in the regulated fields. They are the only methods applied in the industrial field.

The material which follows gives more specific information. The chart shows that in the total financing for all types of securities, public offerings, that is, both competitive and negotiated combined, predominated. They represented 61% of the total in 1959, with the balance of 39% by private sale. However, private sale was more important for debt issues than indicated by the chart, because the chart includes preferred and common stocks. Practically all commons are sold publicly.

CORPORATE SECURITIES OFFERED FOR CASH SALE IN THE UNITED STATES
1934-1959



Source: Securities and Exchange Commission

Since this chapter deals in senior securities, and since debt represents most of the senior security financing, let's now look at how the three methods were used in debt financing. The extent of use of each method will vary from year to year, as indicated from the following figures:

| | *% of Total Debt Financing*[1] | | |
|---|---|---|---|
| | *1958* | *1959* | *1950-1959* |
| Competitive Public Offering | 26%[2] | 24%[2] | 60% |
| Negotiated Public Offering | 40%[2] | 25%[2] | |
| Private Sale | 34% | 51% | 40% |
| | 100% | 100% | 100% |

[1] *25th Annual Report* (page 235) and *Statistical Bulletin* (June, 1960), Securities and Exchange Commission, Washington, D.C.

[2] Estimated from figures of *Investment Dealers' Digest, Corporate Financing Directory*, Data from Securities and Exchange Commission, Washington, D.C.

As previously stated, the picture varies with the type of industry, with competitive public offering predominating in the railroad and utility field and being almost unknown in the industrial. Private sale is used to the greatest extent for debt securities of industrial companies, with the next largest category being utilities, mostly gas companies, some of which are not required to go competitive by regulation. For example, there is shown below the

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to regulation of the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935 must sell all types of their securities competitively as provided by Rule U-50, with few exceptions. Many companies not under the jurisdiction of the Act, but in some cases subject to the Federal Power Commission or State Commission regulation, are required to sell their securities competitively. Massachusetts was the pioneer in passing such a Statute in 1870 for certain securities.

use of private sale by types of industry for 1959.[7] In that year, $3.8 billion of securities (97% debt issues) were sold privately.

| | *% of Total Private Financing* |
|---|---|
| Manufacturing | 26% |
| Financial and Real Estate | 26 |
| Electric, Gas and Water | 18 |
| Transportation, Other than Railroad | 17 |
| Other (Extractive, Commercial, Communications, and Railroad) | 13 |
| | 100% |

As will be discussed subsequently, there are considerable savings in financing costs for private sale over public sale for small issues. This is the reason that the greatest number of issues sold privately are of small size. This is shown in the table below for debt issues sold privately in 1951, 1953, and 1955, classified by size of issue.[8]

| *Size of Issue (in $ millions)* | *Number of Debt Issues Sold Privately* | *Amount of Proceeds of Debt Issues Sold Privately (000 omitted)* |
|---|---|---|
| Under 0.3 | 202 | $ 40,323 |
| 0.3- 0.4 | 228 | 79,665 |
| 0.5- 0.9 | 394 | 245,631 |
| 1.0- 1.9 | 463 | 550,030 |
| 2.0- 4.9 | 406 | 1,065,981 |
| 5.0- 9.9 | 196 | 1,016,871 |
| 10.0-19.9 | 130 | 1,312,179 |
| 20.0-49.9 | 94 | 1,971,541 |
| 50.0 and over | 56 | 2,917,907 |
| TOTAL | 2,169 | $9,200,128 |

As can be seen from this three year period, well over half of the number of debt issues sold privately were under $2,000,000 in size. Now we will turn to the question of how each of the methods works. We will start with competitive bidding, because this method requires the greatest number of steps and detail. It will provide excellent background material for an explanation of the other methods.

## COMPETITIVE PUBLIC OFFERING

As we said in the introduction to this chapter, we will give you two complete examples, step by step, of methods of financing. We will start here with our first one on competitive bidding. You will obtain a firsthand picture of much of the general machinery and mechanics of selling any type of issue through underwriters.

### *Steps in Competitive Bidding—A Complete Example*

To use as our example, we have chosen an offering of $50,000,000 principal amount of bonds of Consolidated Edison Company of New York, Inc., henceforth referred to as Con Ed. In getting ready for a security offering, as was pointed out in Chapter IV, "Financing Program," a company must prepare a time schedule with its counsel,[9] giving in detail the things to be done from the conception of the financing until its completion. This is necessary to assure a smooth operation of the financing, avoid delays, reduce overtime, and keep down costs, particularly printing costs. A schedule will include most of the items shown below under the part played by the company.

Each step taken by the company and underwriter are so identified. The manager of our underwriting group is Halsey Stuart & Co., Inc., one of the leading investment banking firms. It will be referred to as Halsey, the name the Street uses. The procedure followed by Halsey is basically similar to that of other firms. While Halsey is doing the things described in each step marked "underwriter," the managers of other underwriting groups who expect to compete for the issue are taking similar steps.

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[7] Data from Securities and Exchange Commission, Washington, D. C.

[8] *Cost of Flotation of Corporate Securities 1951-1955*, Securities and Exchange Commission, Washington (25) D. C., June, 1957, page 62.

[9] As a first step, the company must pick a tentative date for the bidding which does not conflict with other issues.

A time schedule prepared by a company would include dates. However, in our explanation, in order to show the time interval throughout, the number in the left-hand column next to each step is the number of days before the bidding day. In other words, the left-hand column is a "countdown," as for a missile launching, to the "zero" day, the "blast-off," when the company either sells its bonds by accepting a bid, provided, of course, that some bids are received, or rejects them all. The number of days taken by each subsequent step after the bidding day to complete the financing, will be designated by a plus sign.

The first thing a person not following new issues would note regarding the offering would be an advertisement on May 23 in a leading financial newspaper, requesting bids a few days hence on June 3. *The Wall Street Journal* is often used for this purpose. The heading for the advertisement for our bond offering follows.

CONSOLIDATED EDISON COMPANY OF NEW YORK, INC.
Public Invitation for Bids for the Purchase of
$50,000,000 First and Refunding Mortgage Bonds,
% Series O, due June 1, 1988
(Coupon rate to be specified in the bids)
CONSOLIDATED EDISON COMPANY OF NEW YORK, INC.
hereby invites bids, subject to the terms and conditions herein stated.

The advertisement included, among other things, the following information:

1. Where the papers, etc., describing the bidding requirements may be examined.
2. Where prospective bidders may meet with company officials to obtain answers to questions which may arise when they analyze the company and this financing. This is called the Information Meeting or the Due Diligence Meeting.
3. The time and place to hand in the bids.

This advertisement gives us a good basis for starting off the discussion of competitive bidding. However, it is largely a formality which is looked at by people in the financial community primarily for the three facts mentioned above. The underwriting houses who expect to bid obtain even these facts prior to the advertisement, either directly from the company or by word of mouth in the Street. Actually, before the advertisement has appeared, the wheels of finance have been turning for some time in preparation for the offering.

Before we start on our schedule of steps, some explanation is necessary to show what to expect.

The initial step taken by the prospective underwriters of an issue is the formation of bidding accounts, that is, groups of underwriting firms which act together in making a single bid. This is handled in each firm by the Syndicate Department. Unless the size of the issue is small, that is, below about $5,000,000, it is probable that any firm which wishes to submit a bid will want to do so in association with other underwriters. This is for the purpose of spreading the risk and to avoid tying up capital in a few issues. The formation of an account is undertaken promptly when it is first known that the financing is in the offing. Information as to the financing plans of a particular company comes from a number of sources,[10] and underwriting firms are ever alert to acquire this knowledge. A firm which desires to form and manage a bidding account must compete with others which have the same objective. Thus, it behooves a prospective manager to extend invitations to the firms his own firm wishes to have associated with it as promptly as possible upon receipt of knowledge of the new issue. Also, a firm which wishes to join an account to be managed by another promptly should seek a place in a bidding account of its choosing.

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[10] Some of the sources of information on forthcoming financings are: direct contacts with officials of the company, some of whom may be seeking advice as to financial plans; an article in the newspapers; information appearing on the news ticker; a meeting of the New York Society of Security Analysts at which some officer of the company discloses its financing plans; the prospectus relating to other types of financing of the issuer; company's annual report; one or more of the services giving financial information; other dealers; reports that competitors are forming bidding accounts; official invitation requesting bids; etc.

In each account, there is a manager, who is referred to as Manager, Head, or Representative. The others are called account members. For our group Halsey is the Manager. It is generally the larger firms, with adequate personnel and the financial capacity to assume relatively large underwriting commitments, which form and act as managers of corporate bidding accounts. Their position of leadership is based on experience and ability in setting up important underwritings and upon their history of success in this field.

Let us suppose that an underwriting firm hears of a prospective bond issue and decides to form a bidding account. Naturally, each managing firm wishes to form as strong an account as is feasible. In selecting the firms to be invited into the account, the manager gives consideration to such factors as underwriting capital, ability to distribute securities of the type in question, market judgment and willingness to assume underwriting risks. If a managing firm had previously managed an account which had bid on a prior issue of the company in question, it naturally would endeavor to form a new bidding account including firms which were associated with it on the prior issue. If the current issue is of an amount comparable to that of the previous one, the problem is then relatively simple. However, if the amount to be sold differs materially from the amount of the previous issue, it may be necessary to reduce or increase the size of the account. On a few occasions, where the size of the new issue of a particular company represents a substantial increase over a preceding issue, there may be mergers of certain bidding accounts whereby the managers may act jointly or one bidding account may be absorbed into one or more other accounts.

The number of separate accounts that may be formed to bid for a particular issue will depend primarily on the size and the quality of the issue in question. The resources of all underwriting houses do not permit formation of more than two or three groups for very large issues. The current condition of the market may influence the number of bidders. For bond issues which have ranged in size from $125,000,000 to $250,000,000, there have been two large competing groups, and three groups have competed for issues as large as $80,000,000. In contrast, one small issue of $4,500,000 attracted 16 bids.

Now we will begin in our "countdown." We will start from the time when the news was first announced that the company was thinking of doing the financing. If you wish to breeze through the steps quickly, you can do so easily by just glancing at the headings opposite each step. The material under the headings describes what happens in more detail and includes explanation where necessary. Somewhat more emphasis is given to the part played by the underwriter, in order to give you a complete picture of what goes on behind the doors of such an organization.

There are two particular days for which you should read all the material carefully. They are the day *before* the bidding and the day *of* the bidding. They include a description of the meetings of the members of the account and how the bid is arrived at. You must understand this part in order to have a sense of competitive bidding. It will show you how the close contact of the underwriters with potential buyers makes it possible for the underwriters to achieve a good estimate as to the price they should bid.

It should be pointed out that this example is particularly interesting because it shows that some flexibility in time schedule exists in competitive bidding. As will be explained, the offering was postponed after it was started. Thus, the total time that elapsed is not typical.

Our schedule below shows 179 days from the start to the time of the bidding. Of course, some of the time consumed is due to the fact that, being a public utility, the firm had to obtain approval of the state regulatory body. This has no direct bearing on the time required to process a competitive public offering from the point of view of the Securities Act. A more typical time schedule, without delays, was that for the offering of Series *R* bonds by Con Ed, which was authorized by the Board on April 26, 1960. Approval was obtained from the Public Service Commission on May 24. The Registration Statement was filed with the Securities and Exchange Commission on May 6 and became effective May 25. Bids were opened June 14. The schedule included, thus, a total of 48 days from the Board authorization to the bidding date, compared with our example below of 126 days from the day of the Board authorization.

Remember that the numbers at the left of each heading are the number of days before the "zero" day on which bids are received.

179 *Underwriter*—First news of issue—formation of account started.
In December, as a result of a report from a securities dealer, the Halsey Buying Department telephoned one of the officials of Con Ed about a story regarding the construction program the following year. This official mentioned that there was a newspaper article about plant expansion and that the Company might need to sell about $60,000,000 of bonds, but that there was nothing imminent as far as he could then see, there would be no bond financing until the following fall. However, as a result of this conversation, Halsey formed a nucleus of an account consisting of 24 firms, each of which had starting participations of $700,000 and over in the last previous deal consisting of $60,000,000 of bonds for which they bid unsuccessfully a few months previously.

145 *Underwriter*—News of Company's change in plans.
The Halsey Buying Department again checked in January with an official of the company,[11] who advised that while the management had been originally thinking of selling $50,000,000 to $60,000,000 of bonds in the fall, plans might be changed. His guess was that the Company might decide to sell bonds in April or May.

126 *Company*—Directors authorize issue.
The Company had a regular meeting of its Board of Directors at the end of January to authorize the issue and the filing of a petition to the Public Service Commission of New York and filing of a Registration Statement with the Securities and Exchange Commission.

126 *Underwriter*—Formation of underwriting account completed.
Halsey, along with the other managers, was advised after the Company's Directors' meeting that it would sell $50,000,000 of bonds in about three months, that is, around April. The company sent the managers a tentative time schedule. Halsey completed its account by going to the other members who had bid with them on the last preceding account for $60,000,000. There were 118 members located throughout the country in that group.

113 *Company*—Review of bond market.
The Company reviewed the bond market situation to determine whether it was an appropriate time to go ahead with such an offering. It estimated the approximate interest rate and price it might receive, and whether the terms or amount might have to be altered in order to make the issue attractive to purchasers.

The Company discussed the matter of terms and general bond market conditions with some leading investment banking firms. It was advised to go ahead with the offering without making any special change in the terms of the indenture in order to attract purchasers.

Some investment banking firms are willing to give advice free of charge to companies contemplating competitive bidding. This provides an opportunity for a company to check its own independent studies on various aspects of the financing. It may be well to consult more than one firm because there may be a difference of opinion. However, it is unnecessary to contact more than two or three in order to get a good picture of the situation. As a point of interest, one question frequently asked by prospective issuers, when the bond market is tight, is whether or not a forthcoming issue of bonds should have a non-refundable provision in order to make the issue sell at a better price, and the price differential, if it is not included. Other questions which might be asked investment bankers regarding a forthcoming bond issue are: the status of the current bond market; the term of the debt, that is, whether bonds, for instance, should mature in, say, 20, 25, 30 or 35 years or longer, and how much effect the term would have on market receptivity; what constitutes acceptable optional redemption provisions; the amount of sinking fund to be provided and what special restrictions, if any, might have to be included in the indenture under existing market conditions. These are merely brief examples of the multitude of inquiries which are made of certain underwriters by companies contemplating an issue of bonds.

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[11] The company had previously discussed the advisability of such a change with the managers of the groups.

In such discussion with underwriters, the company may obtain some broad ideas as to the interest coupon and price which might be expected to be received. The estimate will only be an approximation, because no underwriting group wants to take a chance that the bid they are thinking about will leak out to any other group.

113 *Company*—Filing with Utility Commission.
The Company which is subject to regulation by the Public Service Commission of New York filed a petition with the Commission, requesting authority to sell the bonds.

99 *Company*—Hearing before Utility Commission.
Hearings were held before a member of the New York Public Service Commission to review the Company's petition.

98 *Company*—Filing with the Securities & Exchange Commission.
Since this was a public offering, the Company had to file its Registration Statement Form S-9 with the Securities and Exchange Commission.

91 *Underwriter*—Manager sends first material to account members.
As Manager of their underwriting group, Halsey sent to the members of the account copies of the following, which were obtained from the Company:

a. Prospective Bidders' Questionnaire—This must be filled in by each of the underwriters in the account and returned to the Company through the Manager.
It covers questions referring to possible affiliation of the underwriters with the Company or trustee, which would disqualify them from being underwriters under the provisions of the Trust Indenture Act of 1939, or the Public Utility Holding Company Act of 1935.

b. A so-called blue sheet, on which each underwriter in the account fills in his exact firm name, address, etc., to be used in any circulars, advertisements or prospectus issued in connection with the financing, and also a list of states in which the underwriter is registered as a security dealer. The latter part is for the purpose of indicating the states in which it may be necessary to get the issue cleared for sale by the state securities commission. This is known as Blue Sky procedure and is handled by the lawyers for the underwriters.[12]

c. Preliminary prospectus, plainly marked that it has not yet been approved by the SEC.

d. So-called bidding papers comprising:
  Public invitation for Bids.
  Statement of Terms and Conditions for Bids.
  Form on which the Bid will be handed in to the Company.
  Form of Purchase Contract between the underwriters and the Company.

88 *Company*—Order received from Commission.
The Public Service Commission issued an order granting the Company permission to sell the bonds.

57 *Company*—Amendment to Registration Statement filed, changing bidding date.
The Company filed an amendment to the Registration Statement with the Securities and Exchange Commission changing the bidding date from 15 days hence to 57 days hence, because of unusual congestion in the bond market.

56 *Underwriter*—Members informed of change in bidding date, revised papers sent.
The Manager informed the account members by letter that the Company had changed its proposed bidding date, and sent members

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[12] In competitive bidding, the counsel to act for the underwriters is selected by the company early in the procedure.

copies of amendment to Registration Statement, Form S-9 revised, preliminary prospectus and other form papers that needed to be updated.

37 *Company*—The Registration Statement as amended became effective.

The registration statement automatically becomes effective twenty days after filing with the Securities and Exchange Commission. A company may obtain permission to accelerate the effective date. Since Con Ed had filed some time previously and postponed financing, the registration statement was already effective. After the winning bid is known on the day of the bidding, a post effective amendment to the statement, including the price, interest rate, redemption prices and winning underwriting group, must be filed before the sale can take place. This automatically becomes effective immediately on filing.

22 *Underwriter*—Manager offered participations to smaller account members.

The Manager sent letters to the smaller individual account members offering them specific participations in the account. Generally these were accepted without complaint.

13 *Underwriter*—Manager sent further material to group members.

The Manager sent a letter to each account member advising them that no new bidding papers would be issued since no changes were contemplated in those last forwarded. Members were sent the following:

a. Blue Sky survey of counsel for the underwriters, which showed the states in which the bonds had been cleared for sale.
b. Survey of counsel as to legality of bonds for investment by savings banks, insurance companies, trust funds, etc. This may be quite important in some issues. It is sometimes difficult to figure whether an issue is legal for investment by certain types of institutions in some states, and if this has not been definitely established before the offering, some potential purchasers will be eliminated.
c. Two copies of final prospectus. It is necessary for each underwriter to arrange with the Manager to have on hand a sufficient supply of prospectuses so that a copy can be sent to each potential purchaser who is offered the issue and does not already have a copy.
d. Drafts of opinions of counsel for the Company and of counsel for the successful bidders, concerning various legal matters.

12 *Underwriter*—More papers sent to members.

The Agreement among Purchasers, that is, the agreement among the members of the account in the underwriting group, and a list of account members in the group indicating the participation of each, were sent to the members.

11 *Company*—The formal advertisement appeared in papers, calling for bids 11 days hence.

This is the advertisement which was used to start off this description of competitive bidding. As we said then, the wheels of finance had been turning for some time before the advertisement appeared.

6 *Company*—Due Diligence Meeting.

The Company held a Due Diligence Meeting at 10:00 A.M. at its office, since it was not far from the financial center. This form of meeting is fully explained in Chapter IX, "Investor Relations." The meeting was attended by representatives of the underwriting groups, and by security analysts from various financial organizations which had an interest in the Company's securities. A representative of Halsey and some of the other account members were present. The Company's representatives included senior officers of the Company, counsel for the Company, counsel for the prospective underwriters, and accountants. The Company's Financial Vice President spoke briefly on the new issue and reviewed the prospectus; then questions were answered by company officials.

6 *Underwriter*—Data to assist in price appraisal, etc., sent to account members. The Manager sent to account members a so-called form of Agenda showing high spots of Bidding Terms; time schedule of meetings of their underwriting group to discuss the issue; estimated expenses, such as legal fees to be borne by the underwriters; legality for investment in various states; redemption features; ratings; other groups of underwriters competing for the issue; amount of bonds to be retained by members of the group for their own retail sales. This material generally includes a statistical comparison of the company with a few other companies of similar size and rating which recently offered bonds.

There was also included a form of market tabulation comparing prices and yields for various series of Con Ed bonds and certain other outstanding bonds of comparable rating.

5 *Company*—Deadline for bidding groups to qualify to bid.
This was the last day on which underwriters could file the questionnaire which would qualify them to bid on the issue. The Company now knew that there would be three bidding groups unless they subsequently withdrew.

1 *Underwriter*—Potential Demand survey of buyer interest, and preliminary meeting of Manager and account members to discuss price.
Prior to any discussion about what price to bid, the Sales Department of the Manager has made a canvass by phone of the principal buyers likely to be interested in purchasing the issue. This canvass is an effort to pry out of the potential buyers the amount of bonds they might be interested in buying if the price is right. Many buyers are not willing to tip their hands; thus it requires a nice bit of diplomacy in order to get as much information as possible. Through long experience in interpreting this information, the underwriters assess, in so far as possible, the extent of the immediate interest in the issue. This estimate aids in forming an opinion about price. The results of this potential demand survey or canvass of buyer interest is known as the "book."

An office meeting was held in the New York office of the Manager and was attended by the head of the firm and representatives of the firm's Sales, Trading, Buying and Syndicate Departments. At this meeting there was a discussion of the current condition of the bond market, after which the Sales Department reported its findings from the canvass of interest of prospective buyers. Following this, each individual in attendance gave his views as to the market worth of the bonds.

A Preliminary Price Meeting of representatives of the account members is generally held the business day preceding the day of bidding. It was held in the office of the Manager, just after the Manager concluded the meeting of his own staff described above. It was attended by 33 members of the account. The purpose was to discuss the condition of the bond market, the significant features of the issuing company and the particular bonds. The Manager made a report on his survey of the interest in the issue, with specific mention of any large institutions which may have indicated an interest. Although not as extensively as the Manager, most individual account members make their own surveys of sales interest and if they have any information differing from or in addition to the Manager's report, they have an opportunity to express themselves at this time. The "book" or potential demand survey by the Manager indicated an interest in the Eastern part of the country amounting from $8,100,000 to $10,450,000, and in the West from $4,050,000 to $6,500,000, exclusive of one large state fund upon which no specific report was available but which was believed to be a potential customer for at least $2,000,000. This was a relatively thin demand. At times, the showing of potential demand will exceed the issue.

The concluding feature of the Preliminary Price Meeting is the expression of views of the various firms represented as to the yield basis on which the bonds should be offered to the public.

These ranged from 3.83% to 3.90%. In the interest of secrecy, the Manager did not express any views at this meeting.

Before we get to the point of finally determining the bid price, it may prevent some confusion in your mind if we review briefly what the underwriters in the account are trying to determine under the leadership of the Manager.

Con Ed has called for bids for bonds with a 30-year maturity. The underwriters are to name the interest coupon,[13] but one of the terms of the bidding is that the price paid to the Company, that is, the bid price, shall be between 100% and 102¾%.[14] Therefore, the underwriters have to decide what interest coupon they will use and what the bid price should be with that coupon, within the specified price range of 100% to 102¾%.

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[13] The bidding terms called for an interest coupon in multiples of ⅛ of 1%. This is a usual provision. It assures that the coupon rate will fit Bond Value Tables figured in such multiples so that yields can be figured readily.

[14] Utility companies subject to regulation of the Securities and Exchange Commission are generally required to receive 100% or better for their bonds, but there are exceptions. Some states have similar limitations. When not so required, there is no objection to a bid below 100%. In fact, some purchasers feel that a price below 100% is more attractive because it gives more room to the call price. However, from the company's point of view it may, in effect, increase the call price.

However, the process of reasoning starts with a determination of the yield to maturity at which it appears the bonds can be sold to the public. Based on the interest coupon and maturity, the yield is translated into a price to the public. This, as well as the yield which corresponds to that price, is referred to as the list price. The next step is for the underwriters to figure how much compensation they should charge for underwriting the issue. As previously explained, this is also called the spread. By subtracting the underwriters' compensation from the list price, a price is reached which is the underwriters' bid for the bonds. Thus, the bid price requires two determinations: the list price and the underwriters' compensation.

| | *3⅞% Coupon* | *4% Coupon* |
|---|---|---|
| To Public—Yield 3.83% | 100.798 | 103.016 |
| Assumed Underwriters' Compensation | 0.700 | 0.700 |
| To Bid | 100.098 | 102.316 |
| To Public—Yield 3.90% | ~~99.560~~ | 101.759 |
| Assumed Underwriters' Compensation | ~~0.700~~ | 0.700 |
| To Bid | ~~98.860~~ | 101.059 |

Since most of the account members were thinking of a list price which would produce a yield to the public in the range of 3.83% to 3.90%, then the interest coupon would have to be 3⅞% or 4% to fit within the specified price range to the company and allow room for the underwriters' compensation to be tacked on to the price to reach the price to the public. This can be seen from the figures given above. They show the prices of those two interest coupons for yields of 3.83% and 3.90% for a 30-year bond. There is also shown what the bid price would be, assuming an underwriters' compensation of 0.70. The crossed-out numbers are outside of the specified bidding prices. If more than one interest coupon will fit, the lowest one is finally used.

It should be emphasized that the discussion at the Price Meeting will involve both the list price and the size of the underwriters' compensation. There may be differences of opinion on both. Some underwriters tend to be willing to push for a higher list price, if there is a large enough compensation, to take care of possible miscalculations; others feel that they are taking less risk by having a smaller compensation with the list price so attractive as to produce a quick sale.

Now we will get back to our story.

"Zero" Day *Underwriter*—Final Price Meeting. Another office meeting was held in the New York Office of the Manager just prior to the Final Price Meeting, for the purpose of further discussion of potential demand, the bid and offering price, and what maximum commitment or participation the Manager was willing to take. At that time the Manager's participation was $2,300,000 bonds.

At this meeting it was agreed that the Manager would recommend, at the Final Price Meeting of the account, a bid price of 101.95 for a 4% interest coupon. This was based on a public offering price of 102.655 producing a yield to maturity of 3.85%, and an underwriters' compensation of 0.705. It was further agreed that at this level the Manager would be willing to increase his commitment, if necessary, from $2,300,000 to $10,000,000, in order to asorb the slack, that is, participations of those firms who indicate they will withdraw from the account if the bid is too high for their liking.

The Final Price Meeting is generally scheduled by the Manager for as short a time before the hour for receipt of bids as will permit adequate discussion for determining the bid and allow for the completion of the paper work necessary in order to hand in the bid. One reason for scheduling this meeting for as late as feasible is that to do so affords members all possible time to secure the latest information on market conditions and sales interest. Another reason is to preserve the security of the bid. If the meeting breaks up too early, some of those present may talk and information on the account's price may spread around the Street like wildfire and get to the competing bidding groups.

Because some underwriting groups, particularly on an issue of large amount, consist of many members, it is not always practicable to allow each and every member to participate in the discussions at the Final Price Meeting. In such cases, the determination of the final bid and offering price is vested in a so-called Price Committee, which consists of firms having participations down to a certain minimum amount as pre-established by the Manager—which in this issue was $600,000. The Price Committee consisted of 24 members.

It has become a fairly general custom to permit account members not on the Price Committee also to attend the Final Price Meeting if they wish. Such members do not partake in the discussions, but each of them present is given the opportunity to declare whether or not he wishes to withdraw from the account if he does not like the price decided upon by the Price Committee. As an alternative, he may change the amount of his participation.

If an account member finds it inconvenient or impossible to attend the Final Price Meeting, such member may exercise the prerogative of filing with the Manager a price limit. This must be done by a certain designated hour in advance of the Final Price Meeting and indicates the maximum price which the account member is willing to bid for the bonds; at any higher bid such member no longer has a commitment to participate in the bid. The Manager had previously received price limits from 18 account members with aggregate participations of $4,000,000, none of whom had headquarters in New York. Two of these limits specified prices for 3⅞% interest coupon, and the remaining 16, representing participations totalling $3,650,000, specified prices ranging between 100.0743 to 102.005 for a 4% interest coupon.

At the Final Price Meeting the Manager reviews the potential buyer interest in the issue and then gives his recommendations to the Price Committee. Each member of the committee is polled to determine the extent to which the committee members are willing to make the bid suggested. Usually some are willing and some are not, and perhaps certain of those who want to make the bid also will desire to absorb some of the slack. If it is found not feasible to achieve a bid at the level first recommended by the Manager, attempts are made at different prices until agreement on a bid is obtained. While the Manager makes the recommendation to the Price Committee, in some instances other members of the Price Committee may hold generally higher views then those expressed initially by the Manager; thus a bid higher than the Manager recommended may be achieved.

On the first canvass of the Price Committee, it was apparent that there would be no trouble arriving at the bid recommended by the Manager, namely, 101.95 for a 4% interest coupon and an offering price of 102.655 to produce a yield of 3.85%. The members were then canvassed to see how many would go through a 3.85% basis for a list price, that is, offer the bonds at a lower yield. Nine members were willing, whereas 15 members of the Price Committee, with participations aggregating $14,850,000, were unwilling. After further discussion it was finally decided that the list price would be 102.655, which would give a yield of 3.85% for an interest coupon of 4%, but that the underwriters' compensation should be reduced so that the bid to the company would be higher. The final bid price to the Company agreed to was 102.0399, making the underwriters' compensation 0.6151.

The extra digits at the end of a bid may perplex some people. As explained above, basically, the way a bid is arrived at is that the account members decide on a proposed list price and deduct therefrom an underwriting compensation sufficient to cover the risks, expenses, and work involved for the particular issue. Any extra digits beyond this, such as two or more nines, are usually the results of someone's whim, but sometimes lead to startling results. Once an issue of $50 million bonds was won by the margin of $0.0001 per $100 bonds. In other words, the margin was $50 on a $50 million issue. Such things are sheer luck.

At the level of 102.0399, three members of the Price Committee dropped, eight non-Committee members in the meeting dropped and two reduced participations, and 16 members not at the meeting dropped because of price limits they had filed. Five small members of the account had dropped before the final meeting. At the end of the meeting and at the agreed-to bid price, slack aggregated $8,750,000. This was absorbed by 22 members including the Manager, whose final participation was $7,950,000. There were finally 97 members in the account with participations ranging from that of the Manager down to the smallest of $100,000.

After determining the bid and the proposed price at which the bonds will be offered to the public, the Price Committee also decides the discounts to be allowed to dealers and the percentage of each underwriter's participation he will retain for his own retail sales. The latter two points will be explained subsequently.

At the conclusion of the Final Price Meeting, the Manager must quickly complete the necessary paper work in connection with executing the bid form and see that the bid is submitted correctly, in proper form, at the place and time designated for the opening of the bids.[15] Some underwriters follow the practice of having one or more representatives of their Buying Department at the place of sale to receive by telephone the bid and the final changes in the membership of the account.

The final bid forms were completed by representatives of the Buying Department of the Manager, who had been given use of desk space of the office of the Company. This work included changes in the list of account members in the group and the amount of their participations resulting from the Final Price Meeting, as well as the insertion of the bid price and coupon rate. A "good faith" check must accompany the bid.

Promptly at the bid hour, just after the bids had been handed in, the Manager's Syndicate Department exchanged bids with the managers of the competing groups, so that the underwriting groups knew who won at the same time as the company opened the bids. This is a customary procedure, but it is quite surprising to company officials who don't know about it and discover that the underwriters knew who won at the same time as bids were being opened. This is done, of course, only after it would be too late for any group to change its bid.

"Zero" Day (Cont'd) *Company*—Bids opened.

The company opened bids at 11:00 A.M. The bids, all specifying a 4% coupon, were:

| | |
|---|---|
| Halsey | 102.0399% |
| Second place group | 101.9099% |
| Third place group | 101.7199% |

The difference between the price submitted by the winning group and other bidders will depend on the type of issue and condition of the market. If the issue is high grade, about which there is little question, and the market is firm and steady, the difference between the bids of the groups tends to be infinitesimal compared with the magnitude of the undertaking.[16] It tends to show how accurately well-known, high grade issues can be priced by competitive bidding. If the difference is great, it may hurt the sale by the winning group because it may be taken as a signal by potential buyers that the issue is overpriced. The difference in bids for Con Ed is considered moderate in view of the circumstances.

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[15] There have been mistakes in bids which were submitted due to the stress and strain of the last minute rush to get the bids in. There was a case of one underwriting group which, through clerical error by the person handing in the bid, put in the interest coupon rate ⅛% too low. The error was obvious and the company, after due deliberation, permitted the bid to be withdrawn. Other instances of mistakes have included handing in the price at which the bonds were to be offered to the public rather than the price to the company. This results in a serious problem for that underwriting group if they win the issue, as would be more than likely.

The Company's Board of Directors was in session and it immediately approved the winning bid. The Company awarded the issue to Halsey and Associates, and a purchase contract was signed by the officials of the Company and Halsey which bound each underwriter severally. The Company and its counsel, working with Halsey's Buying Department as well as with counsel for the Underwriters, collaborated on filing with the Securities and Exchange Commission the final amendment to the Registration Statement setting forth the price, interest rate, redemption prices, and winning underwriting group. This is the so-called "post effective amendment." The final prospectus was thus completed. As is customary, information about the offering terms, underwriters, etc., had been set up in type in advance in respect to each of the bidding accounts to the extent that it was feasible to do so. As previously stated, the post effective amendment automatically becomes effective on filing.

The necessary approval of the price by the New York Public Service Commission was obtained.

"Zero" Day *Underwriting*—Sales machinery gets set.

A final check was made by Halsey's Buying Department on the status of the issue under various Blue Sky Laws. Night letter telegrams were sent:

1. To members, announcing that the issue had been released for public offering the next day, with information regarding delivery and requests for fully registered bonds;
2. To certain selected dealers, allotting them specific amounts of bonds at the list price less the dealers' selling concession of ¼ of 1%—these dealers had previously made requests to the Syndicate Department for bonds;
3. To members who wanted additional bonds over and above the 80% of their participation which all members, including the Manager, had for retail sales.

The Manager retains a certain amount of each member's bonds in the so-called "pot," the rest of each member's participation being available for his own retail sales. The amount retained may vary in each issue. For small issues there may be no "pot." The practice currently most prevalent is for the Manager to keep 20% of the issue in the "pot," leaving 80% for retail sales.

This percentage was agreed to at the Final Price Meeting. "Pot" bonds are for three purposes: (a) Sales to certain large institutions at full list price for the account of all the underwriters. These sales are handled by the Manager out of the "pot" in order to afford a means for such investors to obtain large blocks of bonds to satisfy their requirements and to obviate the necessity of their having to get in touch with many members of the underwriting group to acquire sizeable blocks. (b) Sales to selected dealers at the dealer concession,[17] such sales also being handled by the Manager out of the "pot." In some instances, the Manager may release members of the group to make sales to selected dealers. (c) In addition, individual members may withdraw from the "pot," with the consent of the Manager, any amount of bonds contributed to the "pot" by such member which then remain unsold.

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[16] There have been a few instances of tie bids. One occurred in 1959 when two groups each bid 101.7199% for an issue of $30,000,000 of bonds bearing a 5⅝% coupon. In this case, the tie groups were given a period of three hours in which to improve their bids if they so elected. One group raised its bid to 101.75% and the other to 101.86%, thereby winning the issue.

[17] Frequently, underwriters in the group that lose the bid will fill some orders from investors who are close to them, by taking down bonds from the winning group at the dealer concession. In so doing, they act in the capacity of a dealer.

+1 *Underwriter*—Sales begin.

The post effective amendment was effective and firm sales began. Generally, it is possible to get the Registration Statement effective late in the day of the bid. In any event, firm offers to sell cannot be made without a prospectus; so they are generally held up until the day after the bidding. Actually, on the day before, as soon as the company accepts the bid, phones start ringing in the offices of the members of the successful group. If buyers are interested in the issue they wish to record their interest, so that they will be sure to obtain bonds when the Registration Statement becomes effective and a prospectus is available. If buyers are eager, it is possible that they may rush in and speak for all the bonds the day before the sale. It is illegal actually to sell bonds prior to the time when the Registration Statement becomes effective and without a prospectus. Such illegal practice is called "gun jumping."

Of the $10,000,000 of bonds retained by the Manager in the "pot," there remained unsold at the close of business $5,294,000, and it was estimated that 25% of the entire issue was sold.

The advertisement of the issue shown on the next page appeared in the newspapers. It included the name of the issue, the price and the names of the 23 underwriters with the largest participations. Under today's liberalized rules of the Securities and Exchange Commission, the advertisement may include more information, but it generally does not. This is the so-called "tombstone" advertisement, because it is usually so formal. If an offering is a quick sale, the issue may be largely spoken for by the time the advertisement appears. In fine print in the ad is a statement to the effect that it is not an offer to sell and that the offering can only be made by prospectus. This is legal verbiage necessitated by the Securities Act. This advertisement is primarily a formality. It is of most interest to the lead underwriting houses in the group to show to the financial district and industry the important position that their houses are taking in underwritings. As to the position of their names on this totem pole, many underwriters are very touchy and feel that it is quite important as a matter of pride that they appear as near the head of the list as possible. The advertisement does have some significance as far as the agreement between the underwriters and company is concerned, because some of the clauses permitting the underwriter to withdraw are cut off by the formal offering.

+2 *Underwriter*—Sales effort continues.
There remained $3,503,000 bonds unsold in the "pot."

+3 *Underwriter*—Sales effort continues.
All of the remaining bonds in the "pot" were taken, of which $2,662,000 were taken by one account member.

+8 *Company*—Closing.
There was a closing held at 10:00 A.M., at which time Halsey handed the Company a check for the total bid price for the bonds, plus accrued interest from the day the bonds were dated, less the amount of the good faith check. Some managing underwriters give the company their check for the full amount and collect from the account members. Others have the account members deliver their checks to the company directly, or through the Manager, for their share of the bonds.

The Trustee, on instructions from the Company, delivered the bonds to the Manager, who in turn distributed them to the members of the group and selected dealers for final delivery to the ultimate purchasers.

+21 *Underwriter*—Agreement among purchasers extended.
It was estimated that the deal was about

60% sold. The agreement among account members was extended through the close of business for 20 more days.

+41 *Underwriter*—Syndicate dissolved. The agreement among purchasers, again meaning the account members, was allowed to expire by limitation at the close of business. After these restrictions are removed, the price is free. The opening quotation on the next day was 98¾-99¼. Three weeks later it was quoted 99⅜-⅝.

This offering would be considered as a slow sale by the financial community.

*This announcement is not an offer to sell or a solicitation of an offer to buy these securities. The offering is made only by the Prospectus.*

$50,000,000

CONSOLIDATED EDISON COMPANY
OF NEW YORK, INC.

First and Refunding Mortgage Bonds, 4% Series O,
due June 1, 1988
Dated June 1, 1958

*Price 102.655% and accrued interest*

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*The Prospectus may be obtained in any State in which this announcement is circulated from only such of the undersigned and other dealers as may lawfully offer these securities in such State.*

HALSEY STUART & CO. INC.
AMERICAN SECURITIES CORPORATION BEAR, STEARNS & CO.
DICK & MERLE-SMITH EQUITABLE SECURITIES CORPORATION
LADENBURG, THALMANN & CO. WERTHEIM & CO.
BACHE & CO. BAXTER & COMPANY R. S. DICKSON & COMPANY INCORPORATED
GREGORY & SONS HIRSCH & CO. NEW YORK HANSEATIC CORPORATION
SHEARSON, HAMMILL & CO. AUCHINCLOSS, PARKER & REDPATH
BURNHAM AND COMPANY BURNS BROS. & DENTON, INC.
SHELBY CULLOM DAVIS & CO. FAHNESTOCK & CO. MCDONNELL & CO.
WM. E. POLLOCK & CO., INC. BACON, WHIPPLE & CO.
VAN ALSTYNE, NOEL & CO.

June 4, 1958.

When the underwriters bid on an issue, they try to bid the highest price possible so that they will win, set the price to the public to produce a satisfactory underwriters' compensation and yet sell the issue with reasonable promptness. It is their hope that the issue will be sold on the day that it is offered. Such a sale for a high grade bond issue is referred to as selling fast, or, in Street terminology, as being "out the window." If an issue is mostly sold within a week or ten days, this is considered satisfactory by the underwriters, depending on market conditions. However, if it takes the full period under which the agreement among underwriters extends, usually between 20 and 30 days, then the issue is considered to be selling slowly. If a substantial amount of the issue is still left in underwriters' hands when the syndicate is terminated, then the sale is considered as a very slow one, and far from what the underwriters contemplated when they purchased the issue. In view of the risk of a change in the level of interest rates, the size of the underwriters' compensation is inadequate to take care of the risk if they have to hold much of the issue as long as 20 days. The entire underwriting compensation for this issue of 0.6151 only represents about 0.03% in terms of yield for the bond. Thus, a very small increase in interest rates would make sale of the issue very difficult and the price would have to be reduced accordingly at the expiration of the agreement. Sometimes the agreement is extended for another 20-day period, as was done in the case of Con Ed. Whether this is done will depend on the market situation at the time.

If there is any quantity of bonds left after the syndicate is broken, then the market price will almost certainly drop. Members of the group can then sell or hang on as they wish. Some members sell or, as the term is used in the Street, they "cut and run." In many instances, sad experience has shown that if underwriters don't take their losses and sell, they may regret their decision to hold and continue hoping that the market will improve.

This finishes our step-by-step story of competitive bidding and the explanation that went with it. It should provide tangible assistance to you in deciding on the knotty question of when to use competitive bidding, our next point.

### *Advantages and Disadvantages of Competitive Bidding*

What we will try to do is evaluate the pros and cons so that you can compare competitive bidding with the other forms of financing—negotiated public offering and private sale. Some of the answers are matters of fact and some are matters of opinion, because not all the advantages and disadvantages can be expressed in figures. There are experts in the field of finance who, in all sincerity, tend to favor one method or another. Their opinions may differ quite sharply. An effort will be made to cover this element, although it must be admitted that it will be impossible to do so in a manner which will please all the experts equally.

First, here is a broad statement about the use of competitive bidding, which we will qualify when we get into more detail: the simple rule of thumb is that competitive bidding generally is most applicable to securities which are well-known to the potential investors and which require no very special sales effort on the part of the underwriters to convince investors of their value. When underwriters bid for an issue, there is not the same incentive as exists in a negotiated public offering to do a sales job before the bidding date, because none knows whether he will be the successful bidder. Now for a more detailed analysis.

*Advantages:*

1. An impartial assessment is made of the value of a security in the existing competitive market. The company does not have to negotiate the price or underwriters' compensation. The price the company obtains is established automatically by competitive bidding. The underwriters' compensation is also established automatically as far as the company is concerned, because the underwriters set it themselves according to their over-all appraisal of what they think should be the price to the public. The company may not be able to estimate the price and underwriters' compensation very closely, and thus it is relieved of depending on the underwriters' judgment as is necessary in a negotiated public offering.
2. The underwriters will seek to pay the company the highest price commensurate with their estimate of their ability to sell the issue.

   For high grade types of securities, which are well known to purchasers under normal market conditions, the company may obtain a higher price for an issue through competitive bidding than in other methods of sale. In a rising market, the underwriters may even reach for an issue slightly above the indicated market demand, on the basis that the upward movement of the market may "bail them out." This practice, however, is usually not too long-lived because of the inability to forecast markets. When the underwriters reach too high during a bull market, someone eventually gets burned and there is a corrective reaction.

3. The company is more free to set the terms of the issue which best meet its needs and then let the market pay the best price on the basis of those terms. This may be quite an advantage in some circumstances, when market conditions place the buyers in a strong bargaining position and they are more able to press their demands in a negotiated public offering and particularly in a private sale.

*Disadvantages:*

1. It is sometimes contended that competitive bidding requires a fairly rigid time schedule, and is not very flexible once it is started. However, as noted in the Con Ed offering, the bidding dates can be changed, and a company can postpone the offering with little trouble. It can speed it up only within the limitations of all the formalities which must be completed. A negotiated public offering may be just about as rigid, because all the process of security regulation has to be gone through. The only thing eliminated is the bidding part. One feature which can add to the flexibility of a competitive bidding is to have the terms of the bidding set up so that bids can be called for on 72 hours notice, rather than naming a specific hour at the start.

   If before the bidding day the company decides to postpone the financing or call it off, it should do so a few days in advance so that the underwriters will not go to the trouble of holding their pricing meeting.

   If on the final bid day the company rejects all bids because they are not satisfactory, it may receive some criticism from the Street. The underwriters may feel that they did all the work necessary to enter a bid and then were not given the chance to buy the security. This criticism is in no way justified. Anyone familiar with the procedure should know that a company is completely within its rights in rejecting all bids. The only criticism to which the company lays itself open is that of its financial judgment in appraising the bid price and then rejecting it. If later on the company doesn't do as well, it may look bad. However, this is something the company should be willing to face if it thinks it made a sound judgment on the basis of all surrounding facts at the time. Furthermore, this situation very seldom occurs.

2. There may be some added expense as compared with a negotiated public offering, but it is negligible for large issues. Either method of public offering for small issues is substantially more expensive than a private sale. However, the company may not receive all the benefit of the savings in a private sale. It may be offset to some extent by a lower price being offered by investors.

3. Some underwriters will strongly argue that if there is a bad market situation, with underwriters' shelves overloaded with securities, the underwriters may be reluctant to bid aggressively. In such a situation, a better price may be obtained by a negotiated public offering or private sale.

   This is where there is real clash of opinion. Those who favor competitive bidding will say emphatically that it isn't so; that in a competitive bid, the underwriters will make a thorough canvass of the market and bid for all the market justifies. Those who favor a negotiated public offering say the reverse; that there are inherent risks in the method of competitive bidding as compared to arranging a negotiated offering that will not produce the best price in some poor markets.

4. It may not be suitable to issues which require much sales effort. This is primarily where those who favor negotiated public offerings rest their case. They will explain the campaign that can be put on in a negotiated public offering with dealers throughout the country and with institutional buyers within the limits of the Securities Act. Those who favor competitive bidding will not disagree, but they do point out that the amount of work that can be done with potential buyers is definitely limited by the Securities Act. Furthermore, in a competitive public offering a company can arrange to put forth information itself if it wishes to do so. And underwriters in a competitive bid do some missionary work in stimulating buyers' interest. It is for you to decide for your particular issue the extent of the benefit that might be gained by any extra sales campaign through a negotiated rather than a competitive public offering.

## NEGOTIATED PUBLIC OFFERING

If you have read the steps in a competitive public offering, you will have a good background for public offerings in general. Many of the details of a negotiated offering are similar, and there is no need to go through each step. The brief résumé of a negotiated public offering which follows is for the purpose of bringing out its characteristics in order to assist you in your appraisal of when to use it, and how to proceed.

### *How a Company Decides on Which Underwriter to Use*

The choice of the underwriter by a company may be a result of previous dealings with an underwriter, recommendation of someone in another company, or solicitation by an underwriter. There are a variety of types of underwriting firms, as noted in Chapter VI, and the company should seek one which can best handle the type of offering contemplated.

If a company has a desirable security to sell and it is uncertain of its choice of an underwriter, it may wish to pick out two or three firms to visit before making a decision. Such an approach is perfectly satisfactory but should be handled properly. It would be unwise and unnecessary to visit more than about three. The company should explain to each one visited that one or two other underwriters are being considered. It should outline its plans, provide complete financial statements and information and then allow the firms about a week to study the situation. When the company revisits the two or three underwriters, it should expect to hear their suggestions as to a proposed method of financing and alternate methods, with advantages and disadvantages of each.

Naturally, there will be some discussion of the price at which the security might be sold and the compensation that the underwriters would charge. However, the company should not base its decision on which one to use solely on price and compensation. It should form its opinion on an over-all appraisal. Any price mentioned this far in advance of the offering date would only be a tentative price and might be subject to change due to circumstances which would occur before the offering date. It is not necessarily of too great significance. Thus, reliance on price alone might be misleading.

At this time the company should pick one of the underwriters to handle the deal. The reason this should be done at this time is that, from here on, the company and underwriter will have to work closely together and it would be highly impractical to carry on any further contact with the other underwriters.

An underwriting firm will stress that, in negotiated public offerings, there is an advantage of sticking with one firm for all of a company's financing. This perhaps applies to he greatest extent when the company's business is of a very special nature. The underwriter develops a thorough knowledge of the company's business and can better advise the company on financial policy. However, a company should not by any means feel tied to an underwriting firm. It should expect to get the very best service and it should be alert to any indication that this is not being received. t should not hesitate to make known any dissatisfaction, and if it is not corrected or satisfactorily explained, it should seek out another firm. There is no basic difference in the purchasing of the services of an underwriter from the purchasing of many other specialized and skilled services. Competition must exist in the underwriting business as in the rest of our economy.

Of course, if a company is not well known, reputable underwriters will also have a decision to make as to whether they wish to handle the issue. Securities are their merchandise and they should not have their names connected with companies which do not have good management and which do not appear to have a satisfactory outlook. If the company s a new venture, the underwriters may wish to hire some experts to study the company, at ts expense, so that the underwriters can better decide whether they are interested.

### *Developing the Financing Plan*

Once the underwriter has been chosen, some further study may be made before a final financing plan is developed. The underwriter may wish to visit the company's plants, and obtain more information. He will want to review the company's capital needs for at least three years ahead, and preferably five, so that he can tell whether the present financing is adequate and what are the company's future financing problems. This may result in the presentation to the company of a revised plan n more detail. Then a method of procedure and financing schedule must be worked out between the underwriter and the company. This will include a decision as to who will be on the team doing the work and what each one will do.

### *Formation of the Underwriting Group*

The company may first be asked what other underwriters it might wish to have as members in the group because of some possible past relationship, or because they are located in the company's territory. The company has an opportunity to assist in determining the makeup of the underwriting group. The manager will then decide on the other members of the group on the basis of various considerations, including their abilities to handle the particular issue. A final list will be submitted to the company. The dealers who are to be included in the selling group will be added as they indicate an interest in the issue. These are the *selected dealers.* If a company wishes local distribution of its securities, it will wish to have local dealers favored. A certain amount of the issue can be set aside for them. Those favoring a negotiated public offering contend that this choice of underwriters and dealers by the company gives an advantage over a competitive public offering. However, this advantage is not necessarily entirely lacking in a competitive public offering. It is possible to arrange for certain local underwriters and dealers to be worked into the picture in one way or another. As previously noted under the discussion of the Securities Act, the dealers cannot actually be signed up until the registration statement is effective.

### *Preparation of the Registration Statement and the Prospectus*

This will be done by the manager and the company, along with the lawyers, accountants, other specialists and the like. In so far as possible, the prospectus should present the facts in an interesting manner, since it is the basic sales document. It will have to be checked thoroughly by a lawyer and even rewritten in parts to make certain that it conforms to the Securities Act. It then has to be filed with the Securities and Exchange Commission.

Just before the Registration Statement is filed, the company should discuss with the underwriters the matter of price and compensation under the then-existing market conditions. Once the Registration Statement is filed, it is too late to change underwriters. This step is necessary so that everybody understands what to expect. If the market does change before the underwriters purchase the bonds from the company, the underwriters should so alert the company to avoid any subsequent misunderstanding. Of course, since the underwriters do not commit themselves at this point, price and compensation are of necessity matters of opinion.

### *Educational Program*

For a large issue, the selected dealers should be thoroughly briefed by a series of meetings throughout the country, within the limits of the Securities Act. As previously discussed, this is one of the advantages suggested as favoring a negotiated public offering over a competitive. The underwriters have an incentive to see that the dealers are informed more than would exist in a competitive offering. Also, after the Registration Statement is filed, luncheons and meetings may be held with large potential investors in order to acquaint them better with the forthcoming issue. However, the means employed must be strictly within the bounds of the Securities Act.

### *Pricing and Spread*

The underwriters are not committed for the security until the purchase contract is signed. Just before the signing, there will be a final meeting between the company and the underwriters in order to set the price to the public and the underwriters' compensation. Upon signing, the underwriters agree to buy the entire issue from the company regardless of market reception, except for the "out" clauses in the contract. This was discussed in Chapter VI.

### *Advantages and Disadvantages of Negotiated Public Offering*

The advantages and disadvantages of a negotiated public offering as compared to a competitive offering have been fairly well discussed already. To repeat, the principal advantage is the opportunity for the underwriters to conduct effective information meetings. This becomes more important for securities which are little known by potential purchasers. Further, underwriters may contend there is less of a hazard to them in a negotiated public offering, particularly when markets are adverse, and that they can get a better price from investors by operating on a selective basis rather than having the issue thrown on the open market.

The principal disadvantage as compared to competitive bidding is that in competitive bidding the opportunity is given to every underwriting firm to make the best bid. Whether this is an advantage of competitive public offering will depend on the nature of the security, that is, whether it is sufficiently well known to potential investors so that the underwriters will make bids commensurate with the real worth of the issue. Those favoring competitive bidding suggest that some sales effort may be made in one way or another in a competitive public offering.

A negotiated public offering, of course, leaves the company with the problem of having to negotiate the price and the compensation. It assumes that a company will have sufficient knowledge to handle that negotiation, and that it can rely on the soundness of the underwriters' judgment. An underwriter, of course, wants to stay in business, and you are his client. It should be in his interest to give you a fair deal so that there will be a continuing relationship. As will be seen subsequently, the underwriters' compensation on negotiated offerings is generally more than for competitive offerings.

Private sale will be discussed next. Then it will be compared with both types of public offerings.

## PRIVATE SALE

Private sale is also referred to as private placement, direct placement and private deal. In this book, the term "private sale" will be used.

We have previously mentioned briefly what is meant by a private sale, but it will now be necessary to explain more fully what it constitutes. As we have already seen, under the Securities Act of 1933 a public offering of corporate securities, with certain exceptions, must be registered with the Securities and Exchange Commission and each written offer to sell must be accompanied by a prospectus. Private sale is exempt from such procedure.[18]

One of the characteristics of a private sale is that a company's securities are sold by the company in a non-public offering to the investors. Title to the securities passes directly to the investors from the company. Usually, there is no intermediate purchase and taking of title by an underwriter.[19]

There may be someone assisting the company, who probably will be an investment banker but need not be. If there is such a third party, ordinarily he will act as agent of the company and, in this book, no matter who performs this function, he will be referred to as the agent. His pay will be called "agent's fee," "private sale fee" or just "fee." He will not take title to the securities.

### *Requisites for Private Sale*

The exemption of private sale from the Act applies provided there are three features surrounding the sale:

1. The number of potential investors to which the security is offered are limited in number.
2. The purchasers are informed investors who are in a position to obtain the information as to the merits of the security without the protection of the provisions of the Securities Act.
3. The purchasers buy the securities with the original intention of holding them as an investment rather than for resale.

When the Securities Act first came into existence, test number 1 above was considered quite important. A conventional rule in the Street was to limit the number of potential purchasers to which the security was to be offered to between 12 to 25. As time went on the number was gradually expanded. The Securities and Exchange Commission has never made any pronouncement on number, other than to name it as a factor.[20] In recent years, there have been a few instances in which as many as 100 purchasers have been solicited in a private sale. If the number were indiscriminately increased, the spirit behind the exemption would be violated. The Supreme Court has said, however, that number is not a proper test.

Today, the most important test seems to be the second one given above, the type of purchasers. The Securities Act was primarily designed to protect unsophisticated investors against inadequate and misleading information; hence the prospectus with all the penalties against such practices. The large institutional investors such as insurance companies, trustees of pension plans, investment companies, etc., with their well-trained staffs of analysts, can protect themselves better than the minimum requirements of the Securities Act. Therefore, offerings limited in scope to that type of investors can, under some circumstances, justifiably be exempt. The United States Supreme Court confirmed this idea in a case in 1953 in the following words:

> The natural way to interpret the private offering exemption is in light of the statutory purpose.

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[18] The wording of the Act is: "transactions by an issuer not involving any public offering." Securities Act of 1933, Section 4, Subsection 1.

[19] This also may be true in a rights offering of common stock, but such an offering is not exempt because of the nature of the purchasers, who need the protection of the Securities Act, and it is a public offering.

[20] This was discussed in the earliest release on the subject by the Securities and Exchange Commission, Release No. 285, January 24, 1935.

> Since exempt transactions are those as to which "there is no practical need for application," the applicability of §4 (1) should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."
>
> The Commission would have us go one step further and hold that "an offering to a substantial number of the public" is not exempt under §4 (1). We are advised that "whatever the special circumstances, the Commission has consistently interpreted the exemption as being inapplicable when a large number of offerees is involved." But the statute would seem to apply to a "public offering" whether to few or many. It may well be that offerings to a substantial number of persons would rarely be exempt. Indeed nothing prevents the Commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims. But there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation. . . . The focus of inquiry should be on the need of the offerees for the protections afforded by registration.[21]

It would seem from this wording that the second test far outweighs the first one.

The third test—original intent of the purchasers to hold the security as an investment—is for the purpose of preventing circumvention of the Securities Act by means of a private sale to a few large sophisticated purchasers, who then turn around and resell the securities, without registering with the Securities and Exchange Commission and without a prospectus, to a broad list of purchasers who should be protected by the Act. This test must be met. Obviously, if there is an intent to resell, the exemption does not apply, because the purchasers in effect become underwriters, buying for the purpose of resale. This does not mean, however, that the investors who buy securities at a private sale can't resell them. They can do so, and without registering them with the Securities and Exchange Commission, provided in the first instance they bought the securities with the original intent to hold them as an investment.

There is no fixed time limit as to how long they must be held. The fact that the original purchaser must buy with intent to hold as an investment, requires a thorough analysis of the security by the purchaser and a willingness to assume all risk involved in the security, rather than just the risk of price involved in quick resale to someone else. A company selling securities at private sale may require of the purchasers a letter or statement affirming the purchasers' intent to acquire for investment. This is for the purpose of protecting the company. On the other hand, the investors may require that the company agree to use its best efforts to register the securities in case they should decide later to sell them. This protects the investors against the expense of registering if the SEC later requires it. On convertible issues, as with warrants, the stock may have to be so registered.

The third test obviously eliminates an investment banker from acting as an underwriter, as defined in the Act, in a private sale, because an underwriter by definition does not purchase for investment but for redistribution.

We can summarize the above discussion in a definition: a *direct sale* is an offering of securities by a company, with or without the assistance of an agent, to informed investors not indiscriminately unlimited in numbers, who have original intent to purchase for investment purposes and not for resale.

### *Agent's Use*

In either a competitive or negotiated public offering of senior securities, you will use an underwriter, but in a private sale you have a choice as to whether to handle the sale yourself or use an agent. Therefore, before we get to our example of private sale, we will give you the pros and cons to weigh in answering the question: *should you use an agent?*

The agent need not necessarily be an investment banker. Some consulting firms assist with private sales. An investment banker has advantages because his regular dealing in securities keeps him in close contact with prices of securities, potential purchasers and terms in recent offerings.

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[21] United States Supreme Court, June 1953, Securities and Exchange Commission *v.* Ralston Purina Company (346 U.S. 119, 125).

The advantages of using an agent, assuming that he is an investment banker or that he is equally qualified to act as an agent, are as follows:

1. He should know the potential purchasers who will be most interested in the issue. If a company has only a limited knowledge of the potential purchasers, it may miss the best possible market.
2. He is thoroughly familiar with the current market for securities and can assist the company in deciding on the price it should receive, and the terms necessary to attract purchasers.
3. He can assist in negotiating with the purchasers both as to price and terms. The agent, being in between the two, is in a better position to bargain than the company dealing directly. The company should not delegate this job entirely to an agent, however, because the agent may have a tendency to favor terms which will facilitate closing the deal quickly in order to minimize his time and effort. In fact, a company should be certain that the agent gives no indication that he is trying to favor the buyers in order to compensate them for past tough deals or to keep their goodwill for future deals.
4. He can advise the company on financial policy, as to type and amount of security to sell.
5. He can prepare the company's story to present to purchasers with the company's assistance, so that it will put its best foot forward by including all necessary information in the proper form. Furthermore, there is some advantage to the agent doing the job, because the agent can appraise the situation more favorably than the company itself without appearing self-serving.
6. He can do a "no name canvass" to determine potentially interested purchasers. This is discussed subsequently.

The buyers of securities generally have no objection to having an agent introduce the issue or be a party to the negotiations. The only disadvantage of using a competent agent is the cost. While it is relatively little for a large, high grade bond or preferred stock issue, it increases for small issues and ones which are more speculative and harder to sell. Figures on cost are given subsequently.

On the average, agents are used in about half of the number of debt issues sold privately.[22] They tend to be used more for larger issues than small. Size of issue is a factor because of the higher relative cost for small issues. Whether a company uses an agent will depend on the experience of the company's financial officer, the character and size of the security being offered and the conditions of the security market.

### *Steps in Private Sale—A Complete Example*

Since the procedure in private sale is quite different from either type of public offering, we will outline the steps which are taken as we did for the competitive public offering. This will help you see how private sale works and assist you in deciding whether it is best suited to your financing. Explanation will be included where necessary.

Instead of using dates when each step is taken, we will use the same method of countdown by days up to the time the company has obtained an agreement as to price and terms, the day of the moral commitment by both parties. That date will correspond to the day in competitive public offering when the company receives bids, or in a negotiated public offering when the underwriters sign the agreement to purchase. Thus, the figures in the left-hand column opposite each step are the number of days prior to the day when the company knows it will get the money and the price. The number of days taken by each subsequent step necessary to button up the financing will be designated by a plus sign.

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[22] *Cost of Flotation of Corporate Securities 1951-1955*, Securities and Exchange Commission, Washington (25) D. C., June, 1957, page 62.

Our example is an industrial company which has decided to sell $5,000,000 of debentures to retire short-term bank loans. The material is disguised, but it is based on an actual offering. We are assuming that the type of financing is such as to justify private sale as the best method.

The company's Financial Vice President has not done any long-term financing in recent years and is not familiar with the best potential purchasers, or security markets. Therefore, he has decided to use an underwriting firm as an agent to assist him.

24 *Company*—Choice of agent—preliminary conference with investment bankers.

The Company sold some common stock through an underwriter ten years ago and was satisfied with the performance of that firm; so the Financial Vice President decided to use it as their agent. If the Company had not already had an investment banking firm in mind, it could choose one in the manner explained under a negotiated public offering, by visiting two or three firms. But it should make its choice before proceeding further with sale of the issue.

The Financial Vice President visited the investment banking firm to have a preliminary discussion. He outlined his financial requirements, explained why he had decided on debentures, went over his financial statements and discussed the feasibility of private sale. The investment banker suggested that because the Company was not very well known—it was only moderate in size, and it was in a highly competitive field—the debentures would barely have the equivalent of *A* grade credit rating, even though they would represent a moderate percentage of total capitalization.

The investment banker was asked his fee to act as agent, and his reply was ¼ to ½ of 1% of the principal amount. He would think the matter over and let the company know a definite figure at their next meeting. The investment banker outlined the type of report for the Company to prepare for review at their next meeting. In the meantime, the investment banker would make a "no name canvass" for a potential purchaser.

23 *Agent*—"No name canvass."

In a private sale, a security should not be shopped around among potential purchasers. If all of the issue could be taken by one purchaser, then the company should decide on the most likely candidate and work with that purchaser until the deal is consummated or until it becomes evident that the parties cannot reach an agreement. Then another purchaser may be sought out.

If more than one purchaser is required in order to absorb the issue, he will readily agree that others may be contacted. In certain special instances the original one contacted may be willing to bring in others. Or the Company or its agent may do the job. Who will do this should be made clear at the start.

Informed investors will show no interest in a security offered at private sale if the company attempts to offer it to other purchasers at the same time when there is no need to do so in order to absorb the issue. News travels fast in the financial community, and such a wrong approach will cool off a deal. It will make the security shopworn. Once that news gets around, potential purchasers will shy away. There are various reasons why shopping around does not work in private sale. Consider the attitude of the institutional investors. Many securities sold through private sale are of a type that requires much study. A purchaser does not like to go to a lot of trouble and then find out that he may not have an opportunity to buy the issue.

But perhaps more important is the fact that no purchaser wants a price which he may suggest used as a means to trade with other potential purchasers. And if a company shopped around, that is just what would happen. One purchaser would name a tentative price; then the company would merely go to another and say, "I have already been bid such a price; will you make a better bid?" Finally, the following thought naturally runs through the heads of potential purchasers, if it gets rumored around that the issue has been shopped: "There must be something the matter with the security, for no one seems to want it. Why should we bother with it?"

In certain instances, regulatory authorities have insisted in a private sale that "best efforts" be made to assure some competition for an issue. Then the company must offer the security in a limited way to more than one purchaser. It may ask several in succession, provided each knows what is going on, or it might ask each purchaser to submit a price at a certain date. A security must be of a standard quality without any special features for even this limited type of shopping to work. The extent of shopping in such a situation will be dependent upon the regulatory authorities' wishes. The company should, of course, resist being pushed in this direction, and if it is forced to shop, it should explain to any purchaser contacted all the facts of the situation. The chances are that it will get a cool reception from most potential purchasers.

Of course, if a company handles a private sale itself, it may inquire of an institutional investor whether he is interested in considering purchase, but the company is more limited in this respect than an agent. A form of shopping to find out potentially interested purchasers, the so-called "no name canvass" mentioned above, only can be done through an agent or third party.

The agent can talk with investors without mentioning the company's name, but just describe approximately the amount of securities to be issued and the type of industry in which the company operates. Potential purchasers can be asked whether they might be interested in this type of investment. Of course, care must be taken not to do anything which would eliminate the transaction from exemption from the provisions of the Securities Act. Since this form of shopping involves no effort on the part of purchasers and no discussion of price, it is not frowned upon. Its only purpose is to seek out the best market. However, once it is decided to offer the security to a purchaser and the data are turned over to that purchaser for investigation, all shopping should cease.

For our Company, the agent was so familiar with the type of purchasers that would be most interested that, after only three phone calls, it was decided that a particular insurance company would be the best candidate.

20 *Agent and insurance company*—Preliminary discussion.

The agent telephoned the insurance company explaining the name of the Company, the amount of financing, that the money would be needed immediately to repay bank loans, that a report would be available shortly, and asking what terms the insurance company might be thinking of. The insurance company requested a few days to think the matter over.

20 *Company*—Preparation of report.

During the week after the preliminary meeting with the underwriter, the Financial Vice President and his staff prepared a report to be used in the sale as suggested by the agent. The agent, rather than the company, may prepare the report. This will depend on the individual situation.

The report included complete information necessary to evaluate the security: a description of the Company's business, some figures on the industry and where the Company fitted into the industry, complete audited financial figures for 10 years, and pro forma figures for the current year giving effect to the financing.

The Company's financing needs were spelled out with a where-got, where-gone statement, or cash budget, and a statement of how the new money would be used. The report included information as to future financial requirements for the next three years, so that the purchaser could tell whether the financing would be adequate. A brief summary was included of the principal terms of the debenture which the Company desired.

A good report is well worthwhile. It may affect the purchasers' interest; it will speed the decision by the prospective purchasers; it may well affect the price and terms. While preparing the report, the Company discussed some of the points on the phone with the agent. When the report was finished, a copy was sent to the agent, who then visited the Company to go over the properties and get the report in final form.

At this time, the agent said that his fee would be ¼ of 1% of the proceeds of the offering, since it appeared that the financing could be arranged without too much difficulty, and since the Company was preparing the report. The agent showed the Company the fees it had charged on other debt issues recently and that ¼ of 1% was in fact its minimum fee. The Company considered this quite reasonable. The Financial Vice President was acquainted with financial officers of two other industrial companies which recently arranged somewhat similar financings through private sale. One was larger and better known; the fee was ¼ of 1%. The other was smaller and the fee was ½ of 1%. The ¼ of 1% for this issue also checks as being low in comparison with published average figures for similar sized offerings for industrial companies. It is only $12,500, and about the minimum for which it is worthwhile for a large underwriting firm to act.

16 *Insurance company*—Preliminary analysis.

After the insurance company's staff made a brief analysis of material available to them from published sources, the insurance company called the agent back to say that they might be interested in $5,000,000 principal amount, 4%, 15-year debenture with an annual sinking fund of $250,000 resulting in an average term of 9.8 years, with a 10-year non-refundable provision.

The agent relayed this information to the Company, and suggested that the terms were satisfactory as a basis of preliminary negotiation. The Company wished a special call provision and a lighter sinking fund provision for the first few years. The agent suggested that these points be outlined in the report.

13 *Company and agent*—Price discussion.

Because shopping around doesn't work, a company must know well the price it should receive. As stated above, this is one of the advantages of using an agent if a company is not thoroughly familiar with security markets.

The Company had gathered information on indexes of yields on outstanding issues of *A* grade industrial bonds and recent new issues of such grade bonds offered through negotiated public offering, in order to become acquainted with yields on bonds. The agent prepared a similar table as well as a list of recent private sales. In a conference between agent and the Company, it was decided that a 4% interest rate and a price of 100 was generally satisfactory. It appeared slightly on the generous side under existing market conditions, but since the Company wished to press its demands for reduced sinking fund provisions and a special call feature, it was felt that the rate should be accepted.

11 *Company, agent and insurance company*—General conference.

A conference was held at the insurance company, with the following present:

Company Financial Vice President
Company Comptroller
Company Counsel
Agent
Insurance Company Vice President in charge of Industrial Investments
Insurance Company Analyst.

The agent gave the report to the insurance company and explained that the Company wanted reduced sinking fund payments during the next few years because of substantial capital improvements. The Company also wanted the right to retire the debt at 100% for three years if it did so through sale of common. It was considering the sale of common for such a purpose, provided earnings improved and market conditions permitted.

The insurance company representatives had a list of questions. The Company showed where the answers were contained in the report, answered them verbally or agreed to furnish data as soon as they returned to their office. The insurance company requested time to review the report and the Company's special requests on sinking fund and call feature.

9 *Insurance company*—Counterproposal.

The insurance company called the agent and said that they were satisfied, but they proposed that the sinking fund be reduced during the first 3 or 4 years with the average life no longer than 11 years, and that the debt be redeemable at 101 for the first 3 years if it is retired through the sale of common stock. The insurance company, in looking over the Company's financial needs, felt that it should have $500,000 more working capital, and suggested that the amount be increased to $5,500,000.

6 *Company, agent and insurance company conference*—Final conference on principal terms.

All members of the three parties met again to iron out final terms. After much discussion covering all phases of the financing, including indenture provisions, etc., the following was agreed on regarding the principal points which had been in controversy:

a. Increasing the amount to $5,500,000;
b. Sinking fund which would produce an average maturity of 11.1 years;
c. Special call feature of 101 for 4 years if debt is refunded through common equity financing.

5 *Insurance company*—Outline of terms, sometimes called letter of interest, purchase suggestion or memorandum of terms.

The insurance company prepared an outline of the proposed financing and submitted it to the agent. It included interest rate, sinking fund payments, schedule of call prices, outline of restrictive covenants relating to dividends and creation of additional indebtedness and lease rental obligations. The purpose of this is only to reduce the terms of the agreement to writing. It is not an agreement to buy. It is quite important that prior to this point the Company keep each member of its team fully informed of all developments. If a company waits to bring in its experts after the Financial Vice President has agreed to the memorandum of terms, the experts may discover some features which are not workable. After the insurance company has obtained committee approval for the terms, it is embarrassing to have to make changes. Inclusion of all members of the team as soon as negotiations start will avoid this danger.

The memorandum of terms is subject

to satisfactory legal documents being prepared, and the condition that nothing is found out about the Company on further investigation by the insurance company, which is contrary to previous representations.

3 *Company*—Acceptance—moral commitment.
The final terms were accepted by the Company with minor changes. Thus the Company became morally committed.

At this stage of the negotiation, the insurance company expects the Company to go ahead with the deal if its Finance Committee approves. In other words, now is the last time for the Company to withdraw if it has reason to object to the price or the terms. It has happened occasionally that working out all of the terms subsequent to the moral commitment, which only applied to the price and a few of the terms, has taken considerable time and that insoluable disagreement has arisen.

The Company informed the insurance company of the bank that would act as trustee.

"Zero" Day *Insurance Company*—Finance Committee approval, moral commitment.
Before the insurance company representative can morally commit his company, the financing must be passed on by the Finance Committee. The Finance Committee of the insurance company met and approved the deal, and the agent was so informed. Thus, at this time both parties are morally committed to the terms expressed in the letter of interest.

The price is set as of this date just as it is set in competitive bidding on the day a bid is accepted, or in a negotiated offering on the day the underwriters agree to buy the bonds. If interest rates decrease before the final papers are signed, the Company cannot expect to have a change made; nor will the insurance company seek any change if interest rates go up. Billions of dollars of financing have been arranged on this basis, and there have been practically no cases in which either party has welched.

Thus, it was 24 days from the start of negotiations to the time that the Company knew it would get the money and the general terms. As we previously stated, our competitive bidding example was not typical as far as time is concerned; under ordinary circumstances, a competitive bid can be completed, even for a utility, in about two months. The comparison is still not fair, because a utility offering takes additional time due to special regulatory procedure. Although no set rule can be given because of the many variables in each offering, private sale does represent a quicker method of obtaining a commitment on price. In a private sale, much additional time may elapse before the Company gets its money, because there are still many things left to be done after both parties are morally committed. Part of the delay which ensues may be due to the lack of need to hurry, since the price has been set.

+1 *Insurance company*—Preparation of purchase agreement and indenture.
A revised outline of the terms was forwarded to the insurance company counsel for preparation of legal documents.

Outside counsel for the insurance company started preparing the Debenture Purchase Agreement, and Indenture, both of which will be submitted to the insurance company's counsel for review. The Company will pay these fees.

When completed they were released to the Company and trustee for review by their outside counsel. The Company also pays these counsel fees.

Sometimes the legal work has been completed in a week, but generally it takes a month or longer.

+1 *Insurance company*—Representatives visit company.

Two representatives from the insurance company visited the Company's plant to examine the conditions of the building and equipment, familiarize themselves with the products and production methods, meet members of the management and gather statistical data and other information.

They prepared a brief memorandum stating that no unfavorable conditions were found. Subsequently an extensive report was prepared saying that the debentures represented a satisfactory investment.

If there is some uncertainty regarding the credit of the Company, the visit to the plant will take place prior to the signing of the memorandum of terms. Under the circumstances existing in this situation, the memorandum of terms was subject to no unfavorable circumstances being found on examination of the Company's property.

+31 *Company, insurance company and trustee*—Conference to iron out details.

Representatives and legal counsels of the company, the insurance company and the trustee met to discuss the legal documents and iron out any problems. Subsequently, this required numerous phone calls and one further conference.

+109 *Company and insurance company*—Sign Debenture Purchase Agreement.

The Debenture Purchase Agreement, or Letter of Agreement, comes some time after the moral commitment of both parties. It may appear an unnecessary document at this late date. As far as the moral commitment is concerned, it *is* unnecessary; however, it contains certain additional information and provisions, such as:

Conditions which must be fulfilled before the closing, including required legal documents and legal opinions stating validity of corporate existence and the proposed new issue, and the existence of good title to properties.

A statement of existing liens, litigation, taxes, large contracts and conditions of properties.

Agreements to furnish financial statements regularly, and to permit the purchaser to inspect properties, etc.

+110 *Company, insurance company and trustee*—Closing.

A meeting was held at the offices of the insurance company with representatives of the insurance company, the Company and the trustee present, at which time the insurance company delivered a check for $5,500,000 and accrued interest. The trustee, in turn, delivered the bonds to the insurance company—which were dated May 1, the date on which interest started to accrue.

Generally, interest starts to accrue from the date on which the company gets the money. A bond may be dated on any working day of the month, but generally new issues are dated on the 1st. In this instance, the moral commitment was made on April 6 and the bonds were dated on the first of the next month. If it is going to be a long time before the final closing, there may be a commitment fee to the closing date when interest will start to accrue. Thus, if you are seeking information about the time that a private sale is consummated, the interest date may be an approximate clue, or if there is a commitment fee, the date from which the commitment fee started running.

These are the basic steps which occur in a private sale of securities. They will vary with different purchasers and different circumstances surrounding the security; however, the general pattern will be similar and the basic principles the same.

### *Advantages of Private Sale*

The advantages of private sale, from the point of view of the company considering its use, are as given below:

1. *Speed and flexibility*. The Securities Act, necessitating a registration statement, prospectus, etc., for public sale of securities, requires much preliminary work and time scheduling. In a public offering, there is a 20-day waiting period, unless shortened by the commission, between the date of filing of the registration statement and the effective date, at which time the securities may be publicly offered. A private sale can be arranged more quickly because all of this is eliminated. Large institutional buyers of securities will stick to their word once they have agreed to such matters as interest rate. Drawing up the final papers can be done subsequently.

There have been cases, for companies well known to the purchasers, where a commitment has been obtained in a week. Such speed is the exception rather than the rule. It could not be expected for a new and complicated type of situation, but it illustrates this advantage. As previously pointed out, from the day of the commitment on price to the day when the company gets its money may be longer in a private sale than in public offering, because of the details to be completed after the moral commitment.

The timing is more flexible in a private sale. Once the process of registration for a public offering gets underway, a company may hesitate to postpone the offering, because certain of the material will have to be redone in order to bring it up to date when the offering is renewed. The extent to which the material will have to be redone will depend on the length of the postponement. A private sale can more easily be postponed or abandoned. Thus, if for some unusual reason a company needs money in a hurry, or may have some uncertainty about its money requirements, a private sale has a distinct advantage.

Also, if the market for securities is uncertain, then the speed and flexibility of a private sale may appear advantageous. However, this latter point assumes that it is possible to make some judgment as to future movement of the securities markets, which is a hazardous guessing game. In other words, if you used private sale in order to speed up the financing because you thought the market was going to get worse, you would, in effect, be trying to forecast future market movements.

2. *Financing costs savings*. There is no underwriters' spread as such. If an investment banker is used as an agent to assist the company in negotiating the sale, the fee is smaller than the payment to an underwriter if the issue were underwritten and publicly offered.

Financing expenses are lower than with a public offering because there is neither the expense of a prospectus nor of other costs of a public offering.

With all public offerings of debt, there is a trustee whose purpose it is to see that the company complies with the terms of indenture. This means the bondholders' position is protected without their having to watch the details themselves. In some private sales, a note is used as the debt instrument and the trustee is dispensed with. There may be other expenses eliminated, such as listing fees.

The dollar savings in financing costs becomes more important for small issues. The table below brings out the difference, compared to public offerings, by size of issue for total financing costs—underwriters' compensation and expenses combined.

COST OF FINANCING FOR DEBT SECURITIES SOLD PUBLICLY AND PRIVATELY[1]

| | *Percentage of Proceeds* | |
|---|---|---|
| *Size of Issue (000,000 omitted)* | *Public Offerings* | *Private Sale* |
| Under $0.3 | | 3.35% |
| 0.3- 0.4 | | 2.66 |
| 0.5- 0.9 | 11.49% | 2.14 |
| 1.0- 1.9 | 8.17 | 1.56 |
| 2.0- 4.9 | 3.78 | 1.12 |
| 5.0- 9.9 | 1.83 | 0.83 |
| 10.0-19.9 | 1.52 | 0.63 |
| 20.0-49.9 | 1.33 | 0.44[2] |
| 50.0 and Over | 1.19 | |

[1] *Cost of Flotation of Corporate Securities 1951-1955*, Securities and Exchange Commission, Washington (25) D.C., June 1957, pages 38, 64 and 66. Figures for Private Sale are a result of adding together agent's fees and expenses for two different samples of offerings.

[2] For $20,000,000 and over.

These figures on financing costs should be used with caution, because as will be seen when the matter is discussed more fully, they may vary due to factors other than size. However, the figures illustrate that for issues under $3,000,000, the savings in financing cost start to be of real significance.

The savings can readily be converted into dollar amount by multiplying the percentage by the size of the issue.

It might be of interest also to view the savings in terms of difference in yield on a bond for the size ranges in which there are comparable figures in the previous table. For this purpose, we will assume that we are dealing with a bond with a 5% interest coupon and a 20-year maturity, and that both in a private sale and a public offering the ultimate purchasers paid a price of 100%. Then the yield based on the net proceeds to the company, after deducting the financing costs as shown in the previous table, can be compared in the table below.

| | *Public Offerings* | | *Private Sale* | | |
|---|---|---|---|---|---|
| *Size of Issue (000,000 omitted)* | *Net Proceeds to Company* | *Yield at Net Proceeds to Company* | *Net Proceeds to Company* | *Yield at Net Proceeds to Company* | *Difference in Yield* |
| $ 0.5- 0.9 | $88.51 | 5.99% | $97.86 | 5.17% | 0.82% |
| 1.0- 1.9 | 91.83 | 5.69 | 98.44 | 5.13 | 0.56 |
| 2.0- 4.9 | 96.22 | 5.31 | 98.88 | 5.09 | 0.22 |
| 5.0- 9.9 | 98.17 | 5.15 | 99.17 | 5.07 | 0.08 |
| 10.0-19.9 | 98.48 | 5.12 | 99.37 | 5.05 | 0.07 |

It has been assumed that the purchasers paid 100% in each method. As will be pointed later, a company should not by any means expect to realize all of this savings. These are what might be termed apparent savings. Purchasers are well aware of them, and expect to participate by receiving a higher yield. For larger issues, which could be sold satisfactorily publicly, it would be questionable whether any net savings would be realized. However, the picture is different for smaller issues. Financing costs are an important factor accounting for the greater use of private sale for small issues, as was previously pointed out.

3. *Future readjustment of terms.* Due to unforeseen developments, a company may in the future have to seek waiver of covenants, or a change in debt repayment schedules, etc. If a company's debt is publicly held and it is unable to obtain necessary consents, it may have to call all of the outstanding debt and issue new bonds.

In a private sale, it may be easier to make a change, because there may be only one or at least only a small number of purchasers, who are all known to the company. The holders may be willing to make an adjustment. Of course, they may ask for some form of compensation, such as an increase in the interest rate if the change adversely alters their position.

This advantage may be quite important for a company which is not standard in nature and for which it is difficult to foretell the company's future requirements at the time of financing. If a company runs into financial difficulty, and is unable to meet its commitments, bankruptcy or receivership would result with a publicly held debt issue. In a private sale, it may be possible to work out a readjustment and avoid bankruptcy or receivership.

This advantage disappears if the original purchasers redistribute the issue to a broader group of investors. And it does not apply to a similar extent if the company has previously offered another series of the same security or other debt publicly so that there are already a large number of holders.

4. *A complicated financing can be explained to experts.* Private sale makes it possible to explain in detail a complicated financing to a small group of expert purchasers, while negotiations are proceeding. In a public offering, purchasers cannot be approached without a "red herring" prospectus, and then the material covered should be restricted to that included in the prospectus.

This is an important advantage for certain types of complicated offerings which require presentation of forecast figures, not allowed by the Securities Act, for a public offering. In fact, it may be the governing reason in such a situation. A new, untried, intricate deal may have to be financed at the start by a small group of experienced investors. Even if the issue were sold publicly, the buyers would undoubtedly be limited to the same ones contracted in a private sale. Nothing would be gained by a public offering.

5. *Special features.* It may be possible to work out some special feature more readily than in a public offering. The delayed takedown represents such an example. In a delayed takedown, the purchasers agree to take the full amount of the issue. However, the company can postpone receipt of some of its money if it does not need it all immediately. In this way, the company temporarily avoids the full interest payments. On that part of the issue on which there is a delayed takedown, the company will pay a commitment fee, which is far less than the charges on the security itself. For example, the commitment fee might be at the rate of ½ of 1% per annum. There have been instances of short delayed takedowns in public offerings, but not to the extent of their use in private sale. The security markets and surrounding circumstances will determine whether delayed takedown might better be handled by the company borrowing temporarily from banks for its first money requirements, and then doing its permanent financing to repay the bank loans and provide the balance of the needed money.

Another type of feature which has been included in some private sales is an option on the amount of the security, with or without a delayed takedown. For example, if a company is uncertain as to the ultimate cost of a project or how much earnings may be generated for construction purposes, it may wish to have an option to increase the amount. Of course, there will be a fee for this option.

Not only may special features be worked into a private sale, but, in fact, new techniques of financing may be developed, such as ownership of the property by the lender with lease to user. Another example is the use of a dummy company which is the obligor for the securities, which in turn are protected by a contract between the dummy company and the principal corporation using the equipment or plant.

6. *Maintain trade secrets.* If a company has a trade secret which it does not wish to reveal publicly, and the secret would have an effect on the price of its securities, it can feel free to disclose the information, on a confidential basis, in a private sale.

7. *Development of personal lender-borrower relationship.* A small company, which needs funds fairly often and can rely on one institutional lender, may be able to develop a mutual understanding with such a lender so that it has a ready source of funds.

### *Disadvantages of Private Sale*

1. *Limited in scope.* In view of the legal restrictions on private sale, it is applicable only to securities which can be sold to well informed investors. If a large number of investors have to be solicited and some of them are not experts in finance, private sale is out.

2. *Price may be lower.* The price at which the issue is sold will generally have to be lower than could be obtained with a public offering.

In the first place, the purchasers are well aware of the savings in financing costs in a private sale *vs.* public sale, and they expect to share some of the savings. They feel that private sale is possible only because of them.

Furthermore, the investors have only three basic reasons to be interested in a private sale:

a. To get a better price or rate;
b. To get better terms such as are in an indenture;
c. To obtain a substantial amount of the issue as an outlet for their investable funds.

Only when investments are scarce does point *c* exclusively represent the purchasers' main interest in a private sale. Otherwise, the purchasers may expect some additional compensation in one form or another. A possible exception to this generalization may exist in a period of chaotic security markets, when underwriters are hesitant to act with any enthusiasm because of the risks of the situation. Then private sale may produce a better price. The debatable nature of this point was discussed under competitive bidding.

3. *More restrictive terms.* The purchasers are in a relatively strong bargaining position in regard to restrictive provisions. When the securities market is in their favor, they can name certain provisions as prerequisites to a private sale. For example, in tight money markets when institutional investors are able to place all of their money at relatively attractive rates, they will require a non-refundable feature as an absolute necessity. However, in a public offering, it may be possible to avoid this feature, depending on market conditions. This may require a higher interest rate, at times amounting to ⅛ of 1%, more or less. No increase in rate will budge the purchasers in a private sale to give up the non-refundable feature if they are not pressed for an outlet for their funds.

As was pointed out in Chapter V, an effort on the part of buyers to get such restrictive features as non-refundability should not be condemned. They are not being arbitrary or dictatorial. It is their job to get it if they can. It is part of the price the company may have to pay to get money. A company should merely weigh such additional restrictions in deciding whether or not it might be better to go the public route in order to avoid them. Needless to say, a company must thoroughly understand all the possible future ramifications of restrictive provisions in order to protect its own position. If it fails in such understanding, it cannot blame someone else. Some purchasers may try to abuse their position and try to "hog-tie" a company. This is a rare exception. Well informed purchasers are genuinely interested in giving a company freedom of financial action so that it can operate successfully. Their primary concern must be to protect their investment.

4. *No market for sinking fund purchases.* There is no market available in which to repurchase the security for sinking fund or other purposes. When a security is sold at private sale, the terms at which a company can reacquire it are spelled out in the indenture. For sinking fund purposes, the price is generally keyed to the price at which it is purchased.

If a company sells bonds publicly when interest rates are low, and then the general level of interest rates increases, the market price of bonds will fall correspondingly. For example, a bond with a 4% interest rate and 25-year maturity would have the following prices at various yields, as shown in bond yield tables.

| *Yield* | *Price* |
|---|---|
| 4.00% | 100.00% |
| 4.50 | 92.54 |
| 5.00 | 85.82 |

From these figures, it can be seen that if such a reversal in interest rates occurs, a company can achieve a substantial savings, provided there is an existing market for its securities, and it is able to reacquire bonds for sinking fund or other purposes.

Since there is no market for issues sold privately, no such opportunity exists. When interest rates increase substantially, under special circumstances, the purchasers at private sales may occasionally be willing to resell their bonds to the company at a reduced price.[23] However, the company must be in a good bargaining position. This situation might occur where there are a relatively large number of holders and a company has an optional sinking fund, or already has filled its fixed sinking fund requirements and wishes to anticipate future sinking funds. In other words, where the company has a choice as to whether to purchase or not, then the purchasers at private sale may be willing to accept a lower price than provided in the indenture. This is not a usual occurrence, and the price the company would have to pay undoubtedly would be higher than if there had been a public market. Where the company has a fixed amount to provide for sinking fund purposes and there are only one or two holders, it is in a poor bargaining position. In some instances, if a public sale were confined to a limited number of holders, the same situation would occur.

This point represents a very substantial objection to private sale. It should be weighed very carefully when senior securities are sold during a period of low interest rates. Companies which have sold publicly large debt issues with heavy sinking funds in times of low interest rates have saved millions of dollars in repurchase of their bonds in the market to satisfy the sinking fund when interest rates have increased. The extent to which it is possible for the company to retire bonds through purchase in the market, after a public offering, will depend on how well the bonds are scattered among a large number of investors, and on the extent of market activity.

5. *No rating.* The rating agencies feel that there is no purpose in rating an issue sold privately. Ratings are for the purpose of guiding the less informed purchasers as to the general credit standing. The purchasers in a private sale have adequate statistical staffs to arrive at their own rating.

Under some circumstances this may prove to be an advantage. If a company has no ratings on its bonds already outstanding and has to put out an excessive amount of debt due to special circumstances, it may wish to avoid any rating until it has an opportunity to correct its financial picture. However, if the original purchasers do eventually resell an issue to the public, it may then be rated.

If a company already has other series of the same security which were offered publicly, this point does not apply, because the outstanding issues would be rated and the rating would be the same for all series. Nor does it apply if the company has other types of debt publicly held and rated, from which the ratings for various types of debt can easily be imputed.

### *Summary of Advantages and Disadvantages of Private Sale*

Such an array of advantages and disadvantages may make it difficult to determine when a private sale should be used. These pros and cons should be evaluated in each situation. However, it may be well to summarize them briefly.

There are certain types of issues which, by their very nature—new, complicated ventures with risks difficult to appraise—can be handled only through a private sale. They would have to be offered to a small number of well-informed investors. Nothing would be gained by having a public offering. In a public offering, the same buyers would have to be contacted and there would be the added expenses.

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[23] In a private sale, the call for sinking fund may contain a provision that purchases for sinking fund will be on a pro rata basis among investors. If one or more investors subsequently sell their bonds publicly, the provisions still apply to the portion of the bonds held by the original investors. This type of restriction largely eliminates the possibility of purchase below the call price for sinking fund purposes while the bonds are held by the original investors. If there is no such provision, the company may find it worthwhile to try to acquire some cheap sinking fund bonds. Such a procedure is not generally frowned upon by the purchasers at private sale.

Private sale may permit the development of untried techniques in financing.

Aside from these points, the principal advantages are: speed and flexibility of arrangement, the possibility of changing provisions by contacting a few holders in the future, and the saving in financing costs. The saving becomes a real advantage for a small issue and accounts for its greater use by small companies.

The principal disadvantages are that the purchasers may be in a position to obtain a better rate and terms, particularly the latter, and that there is no market in which to repurchase securities for sinking fund or other purposes. This may be a substantial disadvantage if a company has sold senior securities when rates were low and it has heavy sinking fund payments to meet in a period of higher rates.

## PRICING OF NEW SENIOR SECURITIES

When a company offers securities, it must have some idea of the price or rate it may expect to receive. This will be one of the determinants of whether to do the financing. Furthermore, if the company offers the securities at competitive bidding, such information will be necessary in deciding whether to accept a bid. In a negotiated offering, it will be a deciding factor as to whether to accept the underwriters' proposition. In a private placement, the matter of rate is equally as important as in a negotiated offering, particularly if the company handles the financing itself. If it uses an agent to do the negotiating, it will still have to have a good idea of the rate, so that it will know what to accept.

As explained at the start of the chapter, for bonds the rate means the yield to maturity. This can be translated into a price for the bonds by referring to bond yield tables on the basis of the number of years to maturity and interest coupon. For preferred stock, the rate means current yield, which can be translated into price on the basis of a dividend rate.

In solving the problem, the company should first seek to determine the rate at which the security can be sold to the public. Then, in a public offering, the underwriters' compensation will have to be estimated in order to get from the price to the public, to the proceeds to the company. In the material which follows, we will be concerned exclusively with the rate at which the securities can be sold to investors. The next sections cover the underwriters' compensation and expenses.

How is the rate that investors will pay for a new issue of long-term debt or preferred stock determined?

A reply that the rate is a matter of supply and demand, like any other price, is not much help, but the idea is basic in trying to solve the riddle. Therefore, from necessity, we will have to take time to discuss the elements that affect price before we give you an actual example of pricing a security.

On the demand side, there are these factors:

1. The security being offered:
    - (a) ITS QUALITY. This may be exemplified by the credit ratings, which take into account all of the factors affecting the inherent risk. Obviously, the greater the risk, the higher the rate. Privately placed bonds are not rated, but the same principle applies. And while ratings are most often thought of for bonds, the same idea also applies to the quality and risk for other senior securities, such as preferred stocks.
    - (b) THE SIZE OF THE ISSUE. Very large issues may require a somewhat higher rate, meaning lower price, because of the added supply. Very small issues, in the neighborhood of $1,000,000 or less, will undoubtedly require a higher rate, because the purchasers will have to do as much work in analysis of the situation and

will have less investment over which to spread their cost analysis.

(c) SIZE OF COMPANY. Not only does size of the issue affect the rate but the size of the company may also have an additional effect. A small, unknown company will require a higher rate than a larger, well-known company for the same size issue. A small company is less well-known to investors, and there is thus not as much of a potential market for its securities.

(d) THE GENERAL CHARACTER OF THE INDUSTRY. Certain types of industries are more difficult to analyze and have less appeal to investors for many different reasons. They will command higher rates. On the other hand, there are some issues which are known as museum pieces. They are the *creme de la creme* and in limited supply; they command premium prices. Therefore, the rate is affected by the type of industry and company.

(e) THE TERMS OF THE OFFERING. Such factors as maturity, call price, sinking fund, restrictive provisions, etc., may affect the rate.

2. Other media available for investment:
This includes sources of investment of both a similar and a dissimilar nature, but which represent a possible substitute source for investment, and thus compete either directly or indirectly for the purchasers' available funds. This may include both outstanding issues and new media for investment. Similar new issues being offered at about the same time represent the most direct competition, as do unsold issues in the hands of underwriters.

On the supply side, there are these factors:

1. Availability of funds for the type of issue:
The amount of funds that are in investors' hands available for possible purchase of the type of security being offered.

2. The overall supply of funds:
There are many different types of funds seeking investment in the broad field of capital, some short-term, some restricted by certain legal requirements, some seeking tax exemption, some seeking income, others appreciation, etc. There are, thus, many different rates in the money market. There is not complete fluidity of capital from one field to another, but there is sufficient fluidity so that a movement in the rate in one field may have an effect on the supply of funds to another.

3. Potential purchasers' interest in the issue:
The extent to which potential purchasers for the new issue may already have enough of the company's securities. As already mentioned, if a well-known company brings out a new issue of which none is now outstanding, it may command a slight premium. On the other hand, if a company already has outstanding a large amount of securities similar to the proposed new issue, potential investors may already hold so much that they will be less eager to purchase more.

4. Freedom of underwriters' capital:
By this is meant the extent to which underwriters' capital is free; that is, the extent that their capital is tied up with issues which they purchased and have been unable to sell. If the proposed new issue is being offered competitively, this may be quite important. It is less important in a negotiated offering, but it still cannot be disregarded.

5. Action of the Federal Reserve System and other general influences in the money market:
Through its open-market policy, a change in the rediscount rate, or a change in the

> commercial bank reserve requirements, it can influence the level of interest rates through the effect of its actions on supply. There may be other important general influences on the money market, such as U. S. Government fiscal policy.

Now let's determine the yield to maturity at the price to the public for an actual issue. Let's refer to Con Ed, our competitive bidding example, and assume that we are the management of the company on Monday, June 2, making a rough approximation of what might be obtained the next day when the bids are opened. Our job is to arrive at an estimate of the rate from current prices of other securities as nearly similar in nature as possible. We must make allowance for any lack of similarity and for prices which are not current. If we are able to find comparable securities, we ought to be able to arrive at a fairly good guess, if the market stays level.

We should look at both outstanding issues and new offerings. However, since we are concerned with the price for a new offering, we will primarily have to rely on other similar new offerings. They have to be priced lower, meaning a higher yield, than similar outstanding seasoned issues in order to attract buyers to absorb the supply. The price for an outstanding issue is determined by a relatively thin market representing purchases and sales of a small amount of the security. Furthermore, the published quotations for such issues are often nominal and do not necessarily give a good clue as to the market. They should be observed with this in mind.

The extent of the difference in yield between new offerings and similar outstanding issues will depend on market conditions. When interest rates are low and buyers have a large supply of funds to invest, the difference becomes narrow. As interest rates increase, the difference widens out.

While outstanding issues may not necessarily give us a good clue, they should be observed, having in mind that the price for a new issue will have to be lower and the yield higher. We will first look at other outstanding issues of Con Ed. It had a number of mortgage bond issues with which the new issue would be on an identical basis. The *K* and *L* series have maturities and interest coupons nearest to those for the new issue. Market quotations for these issues, preceding the bidding, were as follows:

*Thursday, May 29*

| | *Bid* | | *Asked* | | *Current* |
|---|---|---|---|---|---|
| | *Price* | *Yield* | *Price* | *Yield* | *Call Price* |
| Series *K* | | | | | |
| 3⅜s, due 1985 | 94 | 3.725% | 95½ | 3.635% | 103.73 |
| Series *L* | | | | | |
| 3⅝s, due 1986 | 97½ | 3.77 | —— | —— | 104.67 |

From these figures it would appear that a reasonable yield to maturity might be slightly less than 3.80%, judging from the bid prices that were being offered by investors for the outstanding issues.

The reason for including the call prices is to make certain that the market quotations were not above the call prices so that they might be affected by the possibility of call. Obviously, the prices of these bonds are sufficiently below the call price that there would be no effect.

The interest coupon rate may affect the price. A bond with a very high coupon tends to sell at a slightly higher yield than a low coupon bond with the price at a discount below par. The reason for this is that the price of a low coupon bond generally has more room to the call price. By "room" is meant possibilities of appreciation before the price is checked by the call price. As noted in the above prices, the highest interest coupon shows a slightly higher yield.

Quotations for the bonds of Con Ed may be affected by the forthcoming issue of new bonds. Therefore, we should look at prices of other comparable electric company bonds. The mortgage bonds of Con Ed are rated *AA* by Fitch, *Aa* by Moody's, and *AA* by Standard. As a sample, the quotations for two other bonds of electric companies rated *Double A* and unaffected by current call are shown below:

*Thursday, May 29*

| | *Ratings*[1] *F* | *M* | *S* | *Price Bid* | *Yield* | *Price Asked* | *Yield* | *Current Call Price* |
|---|---|---|---|---|---|---|---|---|
| Indiana Michigan Electric 3⅞s of 1988 | *AA* | *Aa* | *AA* | 100½ | 3.85% | 101 | 3.85% | 105.21 |
| Pacific Gas and Electric 3¾s of 1978 | *AA* | *Aa* | *AA* | 100 ⅜ | 3.72 | 100 ¾ | 3.70 | 106.457[2] |

[1] F—Fitch, M—Moody's, S—Standard and Poor's.
[2] Non-refundable first five years.

The Indiana bonds would suggest a yield slightly better than 3.85%. The Pacific Gas bonds would indicate a lower yield, but this was due partly to the non-refundable feature.

Then, using hindsight, why did the interest coupon turn out to be 4%, the price to the public 102.655% and the yield 3.85%? The principal answer is the fact that, as already explained, outstanding issues generally sell at a lower yield than the price at which similar new issues can be sold.

The spread between outstanding and new issues is illustrated in the chart on the next page, showing an index of yields on outstanding *Aa* issues and like-rated new issues of electric companies.

Now let's take a look at the new offerings just prior to June 3, our bidding date (bot. pg.).

The Public Service of Oklahoma bonds came out early in the month. The rates were higher at 3.90%, but the price rose so that the quotation on the now outstanding issues gives a yield around 3.81%. The two more recent new issues, Gulf and Illinois, indicate a yield of 3.85%. There were no quotations on these bonds because they were still in syndicate. Thus, under existing circumstances, the officials of Con Ed could have estimated just prior to the bidding that the rate to the public would have been about 3.85%, as was actually the case.

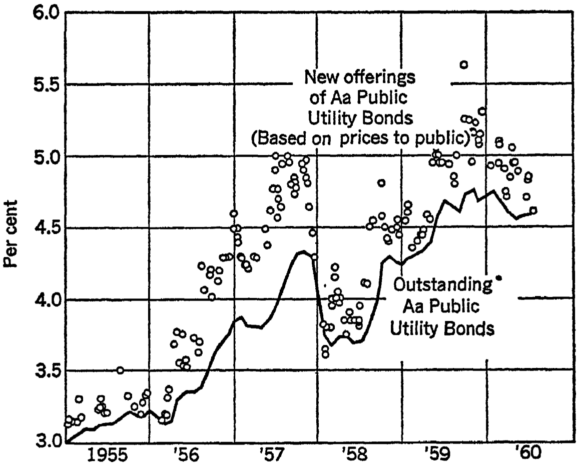
When rates hold level, it is possible, if comparable issues are available, to determine quite closely what a company might receive for a

| | *Date* | *Ratings*[1] *F* | *M* | *S* | *Amount* | *Offering Price to Public* *Price* | *Yield* | *Quotation June 2* *Price* | *Yield* | *Call Feature* |
|---|---|---|---|---|---|---|---|---|---|---|
| Public Service of Oklahoma 3⅞s of 1988 | 5/13 | *AA* | *Aa* | *AA* | $16 Mil | 99.56 | 3.90 | *Bid*<br>101<br>3.82% | *Ask*<br>101⅜<br>3.80 | 103.44 |
| Gulf States Utilities 1st 4s of 1988 | 5/20 | *AA* | *Aa* | *AA* | $20 Mil | 102.655 | 3.85 | (In syndicate) | | 106.70 |
| Illinois Power 1st 4s of 1988 | 5/21 | *AA* | *Aa* | *AA* | $25 Mil | 102.655 | 3.85 | (In syndicate) | | 106.66 |

[1] F—Fitch, M—Moody's, S—Standard and Poor's.

new issue of senior securities. However, this foresight is dependent on being able to obtain an adequate sample of similar new issues and on the existence of a stable market. When the market is changing rapidly, this approach will be inaccurate to the extent of the change that takes place in the market right up to the bidding hour. This may be surprisingly large when a market becomes chaotic. A company, however, can go no further. The underwriters, of course, rely not only on such information, but upon their up-to-the-minute, or even last-minute, appraisal of the interest of potential buyers, on their knowledge of securities pressing on the market and the extent to which unsold issues are on underwriters' shelves. In a rapidly changing market, it is only underwriters, who are close to the market in general and to potential purchasers for the new issue, who can make an accurate appraisal.

Bond Yields



Moody's Investor's Service Inc. Average.

The Con Ed example illustrates the principles involved in determining the yield to maturity and offering price to the public for a new bond issue. The same principles apply for preferred stocks. However, Con Ed represented a comparatively simple problem. The bonds are high grade and of a very standard nature. There were both new and outstanding closely comparable issues. As a guide to comparability, we were able to rely quite heavily on the three rating agencies.

For lower grade issues, and for issues of companies which are not well-known and less standard in nature, frequently found in industrial issues, the matter of finding comparable issues is a more difficult one. Then it may be necessary to rely on issues which are not in fact comparable, and to make an allowance for the differences on the basis of judgment. This requires a more detailed statistical comparison or table, sometimes called a stack-up, showing the principal data and ratios used in security analysis in evaluating such securities. It will include factors surrounding the issue, such as the amount of the issue, rating if available, sinking fund provision, call feature, etc.; and the principal balance sheet and income statement ratios. They will be the standard ones of capitalization and coverage and, in addition, any special ratios which are applicable to the type of company involved. The figures in the stack-up will not reveal the answers directly, because security prices cannot be determined on the basis of mathematics alone. The job requires judgment gained from practical experience in investment analysis. Thus, the Financial Vice President of a company might not be able to come to a very accurate conclusion. However, he must tussle with the problem and arrive at some rough estimate. The level of his ability and the extent of his knowledge in this field will determine the extent to which he will have to lean on the underwriter's judgment. If a company handles a private sale without an underwriter acting as an agent, it may wish to pay a financial expert for a study to show the approximate price the company should obtain. Some underwriting firms may be willing to make such a study for a fee. There are some consulting firms which are qualified to make an approximation.

A special problem arises in using new issues sold through private sale as a guide to determine the price of a forthcoming issue. Most announcements give the principal amount, the interest coupon or the preferred dividend rate, but fail to give the proceeds paid to the company. Another problem which may be equally important is the matter of the date the agreement for the private sale was made. When an issue is sold privately, the public announcement is generally made one, two and perhaps even more than three months after the price was actually established. The public announcement almost never says when the deal was consummated. In order for the price to be meaningful, it must be viewed in relation to the market as it existed at the time that the price was set. If there has been a significant change in the general market, such private sales will be of little value unless the correct date can be obtained. As previously suggested, the day the bonds are dated, or the date that the commitment fee starts running, if there is one, may give an approximation to the day the price was set.

## FINANCING COSTS FOR ALL TYPES OF OFFERINGS

The financing costs to expect when you offer securities will now be analyzed in the following order:

Underwriters' compensation for public offerings,
Agent's fee for private sale,
Expenses for public offerings,
Expenses for private sale.

### *Underwriters' Compensation for Public Offerings*

First, a word about the makeup of the underwriters' compensation. The manager of an underwriting group has the principal burden of work for handling the issue, and gets a fee as compensation. It is a fixed fee determined as a percentage of the total commission. For a high grade bond issue sold at competitive bidding, it may be about 5% of the total amount of the gross compensation. It runs higher for negotiated offerings and may be about 15%. It comes out of the compensation of each member of the group on a proportionate basis.

In order to assist in the sale, the underwriters will offer bonds at a concession to selected dealers. For example, if the offering price is 102, the dealer concession may be ¼ of 1%. Thus, an underwriter would sell bonds at 101¾ to a selected dealer who, in turn, would sell them to an investor at 102, making the ¼ of 1% for his effort. The allowance to selected dealers comes out of the underwriters' compensation. Its size will depend upon how much the underwriters feel that they will need the sales effort of the selected dealers. The allowance has to be enough to induce dealers to spend their time selling the issue rather than trying to make money as a dealer in already outstanding issues, or from some other new issue. For a high grade bond, it is generally ¼ of 1%, but may be ⅓ of 1%. For a high grade preferred stock it may be ½ of 1%. It may be increased for issues not readily saleable, and when market conditions are adverse. Then the underwriters will have to increase their compensation accordingly. As a practical matter, most high grade bonds are sold directly to investors by underwriters, with selected dealers taking a small part. This is partly due to the fact that most underwriting groups are large and the bonds are well spread among account members.

A transaction which takes place entirely outside of the underwriting group is the reallowance which a selected dealer may make to any dealer who is a member of the National Association of Securities Dealers.[24] Let's assume ⅛ of 1% for such an allowance. Then, in our example above, the selected dealer who bought the bonds from the underwriter for 101¾, instead of selling them to an investor, could sell them to a member of the National Association of Securities Dealers at 101⅞. The latter, in turn, would resell them at 102 to an investor. The size of the Selected Dealer Concession has to take into account the size of the reallowance which selected dealers can make to members of the National Association of Securities Dealers.

There are the outside costs which must be borne by all members of the underwriting group, such as the legal fees for the lawyers who represent the underwriters. In competitive bidding, since it is not known which underwriter will win the issue, the company selects a law firm to represent the winning underwriter. Even prior to the bidding this firm has some functions to perform. That is why at a Due Diligence Meeting the question is always asked—how much will be the fees for the lawyers representing the underwriters?

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[24] This reallowance may also be made by members of the underwriting group to members of the NASD.

For certain issues the underwriting firm may hire some other outside experts, such as engineers, in their investigation of the company in order to help them decide whether to do the financing.

The underwriters will generally have to pay interest on bank loans, used to carry the issue until it is sold. However, if the deal sells quickly, the settlement may be arrived at promptly. There may be miscellaneous expenses.

After the above items are deducted (except for the reallowance by selected dealers to members of the NASD) from the underwriters' compensation, the amount which remains is to cover the underwriters' own firm's expenses, underwriting risk, sales effort and a profit on their own capital. Well-known issues may require little work and expense of the underwriters' own staff. On the other hand, a complicated type of financing by an unknown company may need much analysis, investigation and thought to decide upon the best method to apply. To summarize the above remarks we will refer to the figures for our old friend, the Con Ed offering:

| | *Per $100 Principal Amount* | | *Total* |
|---|---|---|---|
| 1. Management Fee for Heading Group. (5% of total underwriters' spread) | $0.0307 | | $ 15,377.50 |
| 2. Estimated Expenses[1] | 0.1070 | | 53,500.00 |
| 3. Total Expenses | | $0.1377 | $ 68,877.50 |
| 4. Allowance to Selected Dealers—¼ of 1%. | | 0.25 [2] | |
| 5. Underwriters' Profit[3] | | 0.2274 | |
| 6. Total Underwriters' Spread | | $0.6151 | $307,550.00 |
| 7. Reallowance by Selected Dealers[4] on their Sales to Members of NASD—⅛ of 1%. (This comes out of the Selected Dealer Allowance.) | | $0.125 | |

The balance represented by item 5 must be sufficient, among other things, to cover the underwriting risk. Let's now review this risk to see what it encompasses and how it may vary.

The risk consists in being unable to dispose of the issue at the offering price. Underwriters expect to price an issue so that it can be sold within a few days. If this cannot be done, then after the underwriting agreement is terminated, usually within about three weeks more or less, bonds may trade in the market at a reduced price and the syndicate members may have to reduce price in order to attract buyers to purchase the unsold portion.

Even though an unusual demand develops when the issue is first offered, the price cannot be increased over the offering price unless an amendment to the registration statement is filed and a sticker is added to the prospectus.

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[1] Expenses cover counsel fees ($12,500) and disbursements, advertising, taxes ($25,000) and miscellaneous expenses.

[2] The amount of bonds sold by Selected Dealers varies. To the extent that bonds are sold by the underwriters themselves, they keep this amount. However, the ¼ of 1% may be looked at as compensation for their own firm's sales effort.

[3] The so-called "profit" must cover the underwriter's own firm expense, interest on bank loans to carry the issue, profit on the underwriter's own capital, etc.

[4] This reallowance may also be made by members of the underwriting group to members of the NASD.

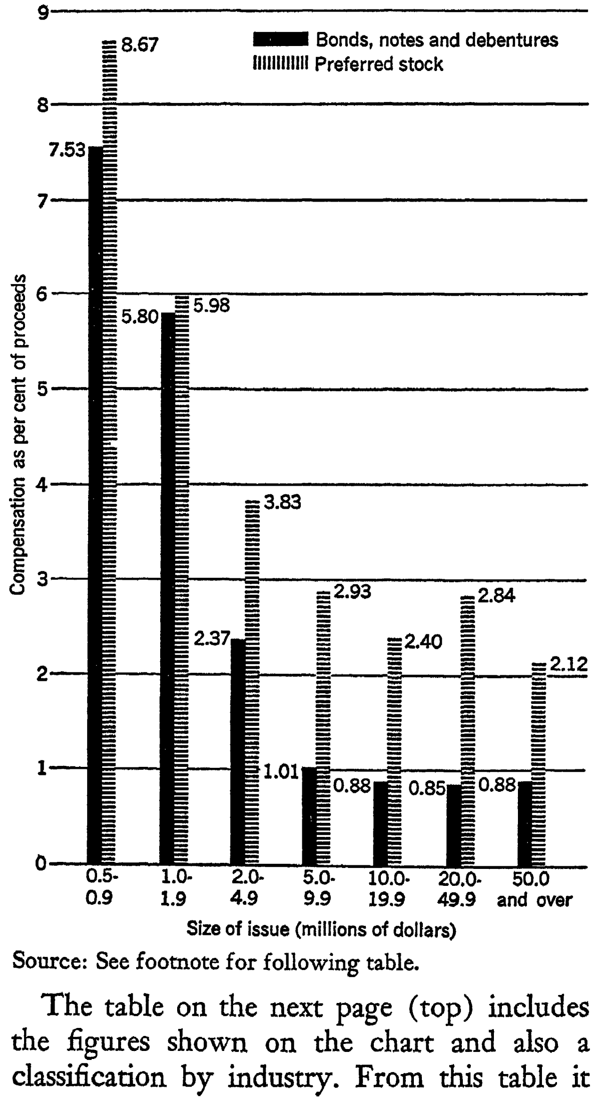
The Securities and Exchange Commission frowns on the idea unless the syndicate is first dissolved. That doesn't happen. When an offering price is set, the underwriters are expected to sell the entire issue at that price if they are able to do so. And it would be circumventing the Act if an underwriter withheld securities with the intention of re-offering them at a higher price after the underwriting agreement is dissolved. Thus, as far as the risk element is concerned, it is a one-way street, and the underwriters must include in the compensation an amount sufficient to cover that risk.

There are three elements of risk: the risk of something happening either directly or indirectly to the company which will affect the security before it is sold (Note that this risk is inherent in any security offering, but it is usually borne by the issuing company. The underwriters' contract has an "out" clause which permits them to withdraw from the issue if the company experiences a material adverse change); the risk of misjudging the demand for the new issue; and the risk of an adverse change in the general market. This element is the most serious, and the one over which the underwriters have no control.

The degree of risk is affected by the elements which comprise the risk of the security, and which determine the acceptable yield for the debt or preferred stock. As the yield increases, the underwriters' compensation tends to increase. These elements were discussed under "Pricing of New Senior Securities." They include the quality of the issue, the size of the company and the characteristics of the industry. The level and condition of the market as it shows investors' willingness to purchase also affects the risk. Obviously, when purchasers are eager for new issues, the underwriters take less risk of getting stuck than they do in a dull market when there is apathy on the part of the purchasers. It is not possible to obtain figures which will isolate the various risk elements, but there are figures which throw some light on the subject. The effect of the size of the issue is shown in the chart which follows. It covers both competitive and negotiated public offerings for bonds and preferred stocks. The compensation starts to increase significantly for issues of less than $5 million, and is substantially more for issues under $2 million.

As would be expected, because preferreds have more risk than bonds, other things being equal, the compensation for preferreds is higher. For the larger issues it is about three times that for bonds, with the difference narrowing as the size decreases.

Underwriters' Compensation for Debt and
Preferred Stocks as a Per Cent of Proceeds
Issues Offered to the General Public
by size of Issue
1951, 1953, and 1955



Source: See footnote for following table.

The table on the next page (top) includes the figures shown on the chart and also a classification by industry. From this table it

UNDERWRITERS' COMPENSATION AS A PERCENTAGE OF PROCEEDS
ISSUES OFFERED TO THE GENERAL PUBLIC
Classified by Type of Security, Size of Issue and Industry of Issuer[1]
1951, 1953 and 1955

| *Size of Issue ($ millions)* | *Manufacturing* | *Elec. Gas and Water* | *Communication* | *Mining* | *Other* | *All Industries* |
|---|---|---|---|---|---|---|
| Bonds, Notes and Debentures | | | | | | |
| Under $0.5 | — | — | — | — | — | — |
| 0.5- 0.9 | 7.42% | — | — | — | 7.69% | 7.53% |
| 1.0- 1.9 | 6.50 | 3.00% | 2.50% | — | 5.25 | 5.80 |
| 2.0- 4.9 | 4.61 | 1.04 | — | — | 4.34 | 2.37 |
| 5.0- 9.9 | 2.58 | 0.73 | — | 3.04% | 2.50 | 1.01 |
| 10.0-19.9 | 1.70 | 0.62 | 0.72 | 1.88 | 1.44 | 0.88 |
| 20.0-49.9 | 1.30 | 0.68 | 0.57 | — | 1.34 | 0.85 |
| 50.0 and over | 1.02 | 0.64 | 0.66 | — | 0.91 | 0.88 |
| Preferred Stocks | | | | | | |
| Under $0.5 | — | — | — | — | — | — |
| 0.5- 0.9 | 11.70% | 8.00% | 5.17% | — | 8.32% | 8.67% |
| 1.0- 1.9 | 8.69 | 4.46 | 4.44 | — | 10.00 | 5.98 |
| 2.0- 4.9 | 4.06 | 2.67 | 4.31 | — | 6.43 | 3.83 |
| 5.0- 9.9 | 3.28 | 2.57 | 4.40 | — | 2.71 | 2.93 |
| 10.0-19.9 | 2.20 | 2.28 | 3.56 | — | 2.23 | 2.40 |
| 20.0-49.9 | 3.23 | 2.76 | — | — | — | 2.84 |
| 50.0 and over | 2.12 | — | — | — | — | 2.12 |

[1] *Cost of Flotation of Corporate Securities 1951-1955*, Securities and Exchange Commission, Washington (25) D.C., June, 1957, pages 38 and 39.

can be seen that the utility industry—electric, gas and water companies—enjoys the lowest compensation, with mining the highest. Note that these data are for 1951, 1953 and 1955. They are the most recent figures available as published by the Securities and Exchange Commission on such a comprehensive basis. In those years, indexes of interest rates for outstanding industrial *Triple A* bonds were in a range of from 3.00% to 3.50%. Because underwriters' compensation tends to increase with interest rates, these figures should be viewed in the light of the interest rates existing at that time.

No distinction in this discussion has been made between underwriters' compensation for negotiated public offerings and for competitive public offerings. Generally, the underwriters' compensation in a negotiated offering is larger than for a competitive offering. This is indicated by the figures (below) for debt issues.

### *Agent's Fee for Private Sale*

Now we turn to private sales. Underwriters' spread as such is eliminated. Where the company handles the sale itself, there is no fee to any middleman. If the company uses an agent,

UNDERWRITERS' COMPENSATION[1] PER $100 PRINCIPLE AMOUNT.
FOR CORPORATE DEBT ISSUES OF $2,000,000 AND OVER.
January 1, 1941, to January 1, 1960

| *Rating* | *Public Utility* | | *Railroad* | | *Industrial* | |
|---|---|---|---|---|---|---|
| *Standard and Poor's* | *Competitive* | *Negotiated* | *Competitive* | *Negotiated* | *Competitive* | *Negotiated* |
| AAA | $0.63 | $1.05 | $0.77 | None | None | $0.88 |
| AA | 0.64 | 1.32 | 0.91 | $1.63 | None | 1.03 |
| A | 0.74 | 1.02 | 1.04 | 1.90 | $1.26 | 1.09 |
| BBB | 1.15 | 1.47 | 1.30 | 1.91 | None | 1.60 |

[1] *A Fifteen-Year Record of Corporate Debt Financing in the United States*, Halsey, Stuart and Company Inc., 123 South La Salle Street, Chicago 90, Illinois.

the fee for such employment is relatively small compared to an underwriter's spread, because the agent assumes no risk, he never owns the security and no syndicate has to be set up. If the security is not complicated, one man in an investment banking firm may handle everything.

The agent's fee is for one or all of four services—advising the company on the best method of financing, finding the interested purchasers, preparing written material to present to purchasers, and negotiating the rate and terms. Its amount will depend on the work involved and will vary from issue to issue depending on the characteristics surrounding the issue. It may be affected by the conditions in the securities market. If the market is poor, more sales effort may be required by the agent and his fee will be higher.

In the chart at the right, there is shown the agent's fee for debt and equity, both preferred and common by size of issue. The fee becomes greater as a percentage of proceeds as the size decreases, because the extent of the agent's effort does not decrease proportionately with size. The fee for equities is higher because more selling is needed.

There is some variation in the agent's fee as a percentage of proceeds among industries, because the nature of a business affects the attractiveness of the investment to investors and the sales effort required. However, this variation among industries is less in private sales than the variation in underwriters' compensation for public offerings.

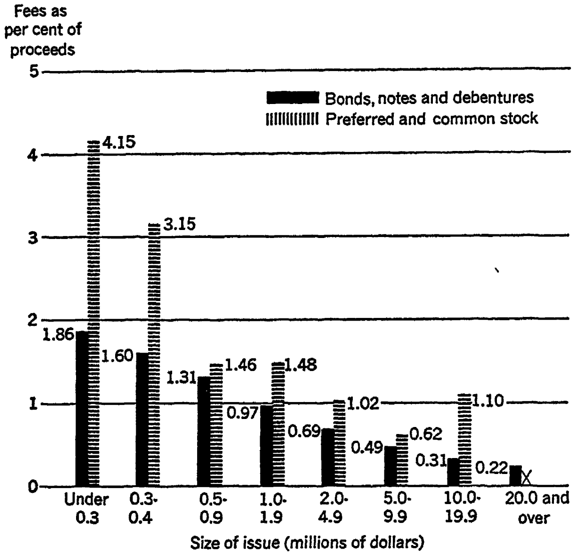
## *Expenses for Public Offerings*

Now we will turn to a breakdown of expenses for public offerings and see how they may vary. These expenses are costs which the company must pay exclusive of work done by its own personnel. There are about nine different categories of expenses which may be incurred for senior securities: 1. Federal revenue stamps; 2. state taxes and fees for "Blue Sky" qualification, etc.; 3. Securities and Exchange Commission fees; 4. listing fees; 5. trustees' fees; transfer agents' fees, etc.; 6. printing and engraving; 7. legal; 8. accounting; and 9. engineering and other special expenses.

Whether each will be incurred and the amount of each will generally depend on:

*The type of security*—As an example, a trustee is needed with a bond issue, but not with a preferred stock.

FEES PAID AGENTS FOR DEBT AND EQUITY[1]
AS A PER CENT OF PROCEEDS
ISSUES SOLD PRIVATELY BY SIZE OF ISSUE
1951, 1953, AND 1955

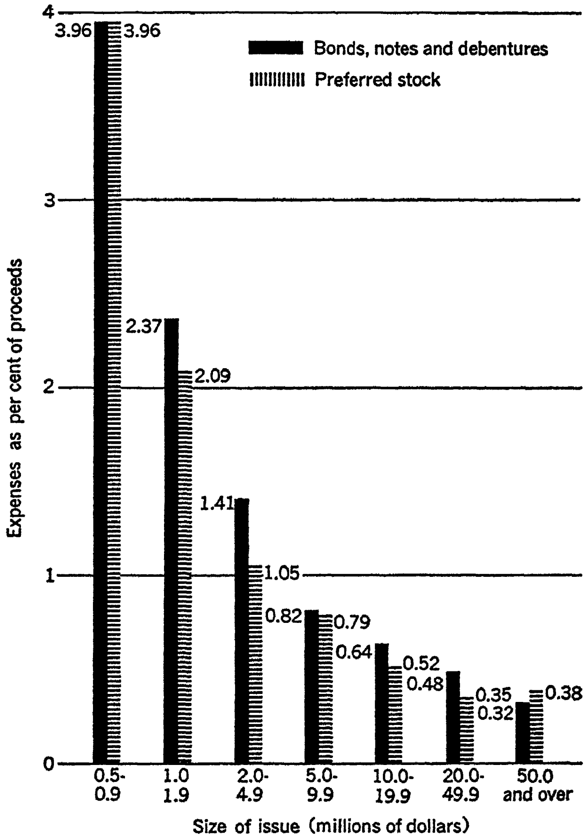


[1] Cost of Flotation of Corporate Securities 1951-1955, page 64. Securities and Exchange Commission, Washington, D.C., June 1957. Separate information not available for preferred and common.

*Size of offering*—Some of the expenses vary directly with the size of the issue, whereas others are only partly or not at all dependent on size. As an example, the Federal documentary stamp is $1.10 per $1,000 of principal amount of bonds and debentures and 10¢ on each $100 of actual value of stock certificates. Thus, this expense varies in amount with the size of the issue. On the other hand, legal fees don't decrease proportionately with the size of the issue, and represent a heavier burden on small issues. Of the nine categories listed above, the first five tend to vary in proportion to the size. The last four do not decrease proportionately with size and consequently increase the burden of expenses for small issues.

*The characteristics of the company*—For a standard type of business corporation the expense items are reasonably uniform. However, there will naturally be variations depending on the characteristics of a company. A complicated situation like that of a mining company may require special engineering fees, an oil company geologists' fees, etc.

Expenses for Debt and Preferred Stocks[1]
as a Per Cent of Proceeds
Issues Offered to the General Public
by Size of Issue
1951, 1953, and 1955



[1] Cost of Flotation of Corporate Securities 1951-1955, page 38 and 39. Securities and Exchange Commission, Washington, D.C., June 1957.

The total expense of 0.81% of proceeds for our Con Ed issue was higher than average for all corporate debt issues of this size. This is due to the large item of New York State Mortgage Tax ($250,000), representing over half of the total.

Two of the factors noted above which cause variations in expenses are size of issue and type of security. Their effect can be seen from the chart at the left.

Itemized Expenses As a Percentage of Proceeds[1]
Issues Offered to the General Public
Classified by Size of Issue
1951, 1953 and 1955
Size of Issue ($ millions)

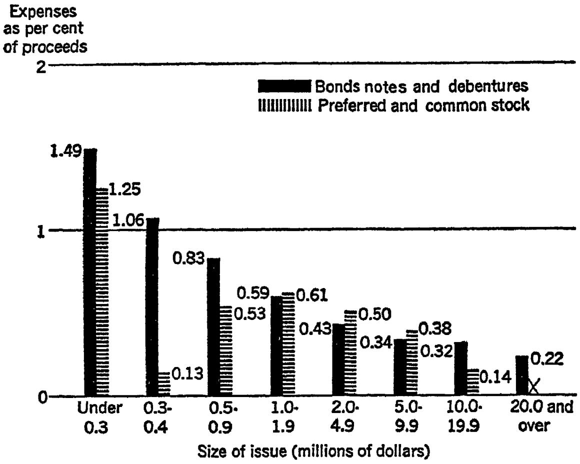
| *Expense Item* | *$0.5 $0.9—* | *$5.0— $9.9—* | *$20.0— $49.9—* |
|---|---|---|---|
| *BONDS, NOTES AND DEBENTURES* | | | |
| S.E.C. Fees | .010% | .010% | .010% |
| Listing Fees | — | .001 | .006 |
| Federal Revenue Stamps[2] | .110 | .109 | .109 |
| State Taxes and Fees | .045 | .038 | .028 |
| Trustees' Fees, etc. | .079 | .106 | .104 |
| Sub-total | .244 | .264 | .257 |
| Printing and Engraving | .811 | .256 | .120 |
| Legal | 1.000 | .156 | .047 |
| Accounting | .289 | .043 | .020 |
| Engineering, etc. | — | .008 | .005 |
| Miscellaneous | .110 | .084 | .031 |
| Sub-total | 2.210 | .547 | .223 |
| Total | 2.454 | .811 | .480 |
| *PREFERRED STOCKS* | | | |
| S.E.C. Fees | .010 | .010 | .012 |
| Listing Fees | — | .002 | .005 |
| Federal Revenue Stamps[2] | .102 | .096 | .112 |
| State Taxes and Fees | .119 | .049 | .013 |
| Sub-total | .231 | .157 | .142 |
| Transfer Agents' Fees, etc. | .064 | .025 | .012 |
| Printing and Engraving | .866 | .212 | .089 |
| Legal | 1.213 | .199 | .038 |
| Accounting | .372 | .059 | .023 |
| Engineering, etc. | — | .005 | .005 |
| Miscellaneous | .168 | .066 | .026 |
| Sub-total | 2.683 | .566 | .193 |
| Total | 2.914 | .723 | .335 |

[1] *Cost of Flotation of Corporate Securities 1951-1955,* Securities and Exchange Commission, Washington (25) D.C., June, 1957, pages 54 and 56.

[2] The figure for the Federal Stamp Tax is based on a percentage of proceeds. It varies in these figures because it may not have been applicable to certain issues.

In spite of the fact that debt and preferred stock issues are quite unlike in their nature, the totals of expense for the same size issues are reasonably alike in magnitude. This is different from underwriters' compensations, which are larger for preferred than for debt.

EXPENSES FOR DEBT AND EQUITY[1]
AS A PERCENT OF PROCEEDS
ISSUES SOLD PRIVATELY BY SIZE OF ISSUE
1951, 1953, AND 1955



[1] Cost of Flotation of Corporate Securities 1951-1955, page 66. Securities and Exchange Commission, Washington 25, D.C. Separate information not available for preferred and common.

If you want further elaboration of figures, refer to the table on page 237. The figures do not include all the issues which were included in the chart, so they are not strictly comparable, but they do give a breakdown by items of expense for these size groupings of offerings. Since some note issues do not provide for a trustee, the indicated average trustee's fee may be somewhat lower than the fee actually incurred on any issue which requires such an agent. Also, note issues might not require any engraving.

In comparing the preferred stock items with those for debt issues, there is one elimination and substitution. For a preferred stock there is no trustee, but a publicly-offered preferred requires a transfer agent and registrar.

No distinction in the above discussion was made between expenses for competitive issues and those incurred for negotiated issues. The table below indicates the slightly higher cost on the average for competitive offerings.

### *Expenses for Private Sale*

Now turning to private sale, we find a definite saving in expense items. The S.E.C. and Listing Fees are out for both debt and preferred issues. The printing and engraving fee is markedly reduced for both types of securities, because there is no registration statement and prospectus, and there is less engraving of certificates. The accounting and legal fees may be reduced because strict regulations will not have to be complied with. Very roughly, a private sale reduces expenses about half for issues under $1,000,000, with less saving for the larger issues.

SUMMARY OF EXPENSES FOR
PUBLIC OFFERINGS OF NEW DEBT ISSUES
OF $2,000,000 AND OVER JANUARY 1, 1948 TO JANUARY 1, 1956[1]

| | *Size of Issue (Millions of Dollars)* | | | | | *Total of All Size Groups* |
|---|---|---|---|---|---|---|
| | *2 to 5* | *5 to 10* | *10 to 25* | *25 to 50* | *50 and over* | |
| Number of Issues | | | | | | |
| Competitive | 76 | 144 | 221 | 109 | 48 | 598 |
| Negotiated | 32 | 29 | 70 | 44 | 37 | 212 |
| Average Expenses per $100 | | | | | | |
| Competitive | $1.23 | $0.87 | $0.64 | $0.52 | $0.40 | $0.56[2] |
| Negotiated | 1.54 | 1.02 | 0.61 | 0.41 | 0.31 | 0.42[2] |

[1] *A Fifteen-Year Record of Corporate Debt Financing in the United States* (Table 9) Halsey, Stuart and Co., Inc., 123 South LaSalle Street, Chicago 90, Illinois.
[2] Weighted average.

The figures are summarized in the above left chart for debt and equity issues by size of issue. Undoubtedly special circumstances caused the low figure for equity for the $0.3-0.4 million size group. If you want further elaboration, look at the table below. The figures do not include as large a sample as those on which the chart is based, so they are not strictly comparable, but they give a breakdown by items of expense for three size groups of offerings.

ITEMIZED EXPENSES AS A PERCENTAGE OF PROCEEDS[1]
ISSUES PLACED PRIVATELY
CLASSIFIED BY SIZE OF ISSUE
1951, 1953 AND 1955

| | *Size of Issue ($ millions)* | | |
|---|---|---|---|
| *Expense Item* | 0.5– *0.9* | 5.0 *9.9* | 20.0 *and over* |
| *BONDS, NOTES AND DEBENTURES* | | | |
| Federal Revenue Stamps | .072 | .083 | .096 |
| State Taxes and Fees | .031 | .014 | .011 |
| Trustees' Fees, etc. | .053 | .030 | .014 |
| Printing and Engraving | .080 | .029 | .014 |
| Legal | .470 | .158 | .069 |
| Accounting | .029 | .006 | .002 |
| Engineering, etc. | .032 | .008 | .005 |
| Miscellaneous | .040 | .012 | .007 |
| TOTAL | .807 | .340 | .218 |
| *PREFERRED AND COMMON STOCK* | | | |
| Federal Revenue Stamps | .083 | .097 | |
| State Taxes and Fees | .008 | .037 | |
| Transfer Agents' Fees, etc. | .001 | .005 | |
| Printing and Engraving | .022 | .028 | |
| Legal | .334 | .120 | |
| Accounting | — | .005 | |
| Engineering, etc. | — | — | |
| Miscellaneous | .018 | .028 | |
| TOTAL | .466 | .320 | |

This finishes the discussion on financing costs. The figures which have been used for illustrative purposes will, of course, not give you an exact approximation of the costs for your financing, since they are averages. However, they should provide a gauge as to the general expenditures to expect.

## REFUNDING

If you have senior securities outstanding which have a high interest or dividend rate compared with existing markets and they can be called for redemption, you should be weighing whether or not to refund them. Two questions will be involved.

What will be the savings?
Should you proceed to refund now or wait for a better market?

An example follows: our Company had issued $10,000,000 principal amount of mortgage bonds one year ago which had an interest coupon of 5% and a 25-year maturity. The bonds are rated *Double A.* They have the following regular call feature: callable on 30 days' notice at 105 for the first year and then decreasing at ¼ point each year thereafter until the price reaches 100. So today the bonds have a 24-year maturity and are callable at 104¾.

Interest rates have decreased. The Company made a study of current rates and asked underwriters what rate the company might expect if it sold new bonds to refund the existing bonds. The conclusion was that new bonds could be sold to the public with a 4% interest coupon and a 25-year maturity at about 100. Underwriters' compensation and expenses would amount to about 1.50, so that the net proceeds to the company would be 98.50. Thus, the cost to the company to raise new money to accomplish this refunding would be 4.10%, as shown by referring to Bond Value Tables.

Now then, we have to decide what to compare the 4.10% cost of our new money with in order to determine the savings in terms of yield. In effect, what we are doing is selling new bonds and reinvesting the proceeds in our old bonds at their call price. Thus, we are interested in the rate to call the outstanding bonds. They have a 5% interest coupon, a 24-year remaining maturity and a call price of 104¾ (call premium 4¾). The yield at the call price is 4.67%, as shown by referring to Bond Value Tables. On the basis of yield, we would realize a saving of 0.57%, which is a result of subtracting the cost rate for the new bonds of 4.10% from the cost to call the outstanding bonds of 4.67%. This is a gross saving and must be adjusted for the tax effect to get the net savings. Assuming a 50% tax rate, there would be a net saving of substantially one-half.

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[1] *Cost of Flotation of Corporate Securities 1951-1955,* Securities and Exchange Commission, Washington (25) D.C., June, 1957, pages 68 and 72. Separate information not available for preferred and common.

We have answered our first question—What will be the savings? [25] Now, we must decide our second question, whether to refund now or wait? This represents a nice problem of judgment. We must attack the problem in this manner: accept the fact that we cannot forecast interest rates. If the savings are substantial, then go ahead and realize the savings by doing the refunding. For our company, the savings are substantial. We should have no doubts in our mind whether to proceed. But if the savings were less, how do we decide whether they were sufficiently large to go ahead? This is a matter of weighing the extent of the savings in relation to the level of interest rates.

There is a very rough rule of thumb as follows: the yield to maturity for the new issue, at the price the company would receive from the underwriters, should be about one-half of one percent less than the yield at the call price for the outstanding issue, in order to make refunding worthwhile. Note that in this rule, the price on the new issue would be after deducting the underwriters' compensation from the public offering price, but before deducting the expenses of the offering.

However, this rule should be tempered by considering the level of interest rates and their outlook. You would not wish to do a refunding, and then have to repeat it all over again within a relatively short period of time, with duplication of financing costs, if interest rates drop further. If interest rates are at a low level, the refunding operation might be advisable with a smaller difference in yield. The prospects of further potential savings decrease as the level of interest rates declines.

At least, there must be sufficient savings, as measured by a difference in yield, in order to take care of possible adverse security market changes in the period that is required to complete the sale of the new issue and call of the old one. You would not wish to go to all the effort and expense of financing and then find that a small change in the market wiped out the calculated savings. In this connection, you should bear in mind fluctuations in security prices similar to your issue in the time interval involved.

From the above comments, it can be seen that it is first necessary to make a mathematical estimate of the savings to be realized, but that the final decision must be a matter of judgment. The mathematics in itself will not give the answer whether or not to proceed.

It will be noted that the calculations thus far have been based on yield rather than total dollar savings. The reason for this is to express the savings in such a way that it will be easy to apply judgment in terms of bond yields. A company should also make an analysis on a dollar basis, as the size of the issue will govern the dollar savings involved. It should include consideration of the effect of the resulting net increase in taxes. The call premium on the outstanding bonds is immediately deductible for tax purposes, and the financing costs, with exceptions, on the new issue are deductible over the life of the new issue. These deductions would reduce the tax increase resulting from the savings due to the lower coupon rate. It

---

[25] Another approach to the problem of determining the savings is to charge the call premium on the bonds to be refunded, to the cost of doing the new financing. This process is shown below.

| | |
|---|---|
| 1. New bonds—4% coupon, maturity 25 yrs., to be sold @ | 100.00% |
| 2. Less compensation and expenses | 1.50 |
| 3. Net proceeds | 98.50% |
| 4. Less premium to call old bonds | 4.75 |
| 5. Net to company after calling old bonds | 93.75% |
| 6. Cost of old bonds: 5% coupon—price 100% | 5.00% |
| 7. Cost of new money: 4% coupon, maturity 25 yrs. Price 93.75 (line 5 above) | 4.41 |
| 8. Saving before taxes | 0.59 |

This method produces a slightly greater savings because the call premium is written off at the lower interest rate, over a longer period of time.

should be noted that inasmuch as the call premium is immediately deductible for tax purposes, the net expenditures by the company to pay for the call premium are only half of the stated premium. Therefore, the saving derived by applying a tax rate to the savings in terms of yield is understated—in the example used, the net savings after taxes would be increased by approximately 0.03%.

A further item which must be considered is the duplication of interest payments which may have to be paid on both the new and old bond issue until the call is completed. Of course, some income may be obtained from a temporary investment of the proceeds of the new issue.

The example we used was a relatively simple one. Some of the complications which arise are:

1. If debt has a sinking fund or serial maturity, you will have to determine the average maturity to use in calculating the yield.
2. If the call price drops in the future, the yield will have to be figured at each call price, to see if there is a sufficient drop to justify waiting to do the refunding at the lower call.
3. The maturity of the outstanding issue as compared to the new issue may be important. In our example, the outstanding issue had a 24-year remaining maturity and the new bonds 25 years, so that this little difference in maturity was not significant. As the spread in maturity gets larger, there may be some advantage to the longer maturity. For example, if a bond is due, say, in 5 years, the call price is low and the market favorable, then the company might decide to refund at relatively little savings. There might be the advantage of anticipating the maturity at a favorable rate. The maturity problem and how it affects the final decision is again a matter of judgment.

The principles of refunding a preferred stock with another preferred are the same, except that the maturity factor is missing. The yield is a current yield and the tax adjustments are obviously different.

## EXCHANGE OFFERS

Exchange of securities is not really a new offering, but it is largely treated as such under the Securities Act. Exchanges can involve senior securities as well as common stock, and any combination of the types of securities. They can apply to just one security or may involve an entire capital structure in a reorganization, a recapitalization or a merger. An exchange has one feature similar to a new offering in that it involves establishing a value on the old securities and the new securities to be received in exchange. In order to induce the existing security holders to accept the exchange, it will be necessary to offer a premium in the new securities either in the form of better protective provisions, price, or income, or a combination.

Exchange offers require some different mechanics than a new offering and may at times seem vastly complicated. Actually, there are two basic steps:

1. A new security or securities must be devised and created, which may be offered in exchange and which will fit the company's financial requirements. This calls for basic principles of finance. It may be necessary to depart from an ideal capital structure to effect the exchange. The extent to which this should be done will be determined by the urgency with which the old security must be eliminated and the extent of the improvement that might be accomplished as a result of the transaction.
2. A price and the features of the new securities must be decided upon which will be sufficiently attractive to induce holders to make the exchange and will not be unduly costly to the company. This involves appraising values of securities and their returns—which includes determin-

> ing the investors' appraisal of the potential values in the old and new securities. If the old securities have real possibilities of appreciation, the holders may be reluctant to make the exchange unless the offer fully compensates for this potential in one way or another.

Here is an actual example, which, in effect, was an exchange in connection with a merger. An industrial company had outstanding 1,340,641 shares of $20 par value 7% preferred stock (dividends per share $1.40) which was non-callable.

Prior to the announcement of the offer, the approximate price range of the preferred stock had been as follows:

| | *Prior Ten Years* | | *Prior Five Months* | |
|---|---|---|---|---|
| | *Price* | *Yield* | *Price* | *Yield* |
| High | $37 | 3.8% | $33⅜ | 4.2% |
| Average of Highs | 35¼ | 3.9 | 32¼ | 4.3 |
| Low | 26 | 5.4 | 30 | 4.7 |
| Average of Lows | 30½ | 4.6 | 30½ | 4.6 |

The company offered for each 14 shares of preferred $500 principal amount of 25-year 4½% subordinated debentures, which is equivalent to $35.71 principal amount for each share. Any fractional balance of less than $500 was paid in cash at the rate of $35.71 per share.

The holder of 14 shares of preferred had a dividend income of $19.60. On $500 principal amount of debentures, he would receive $22.50 in interest. This would be equivalent to $1.61 in interest for each share of preferred.

When trading started in the debentures the price was slightly above 100%, which resulted in a little over the equivalent of $35.71 principal amount for each share of preferred.

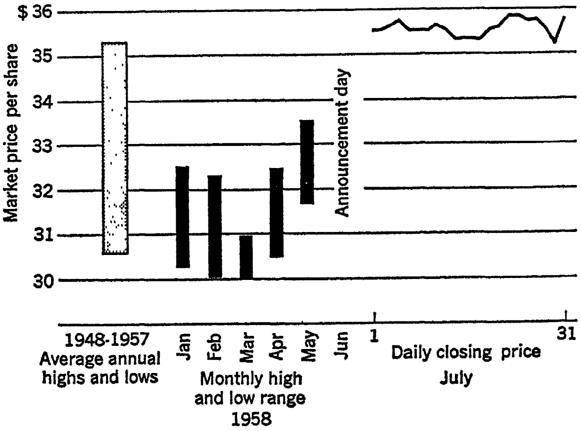
Here, then, is what a holder of one share of preferred received:

| | *Preferred* | *New Debentures Equivalent to 1 Share of Preferred* |
|---|---|---|
| Market Value | $32½ (prior to announcement) | $35.71 |
| Income | $1.40 | $1.61 |

This would appear to be a rather generous offer. Of the preferred stockholders, 86.9% voted for the plan, 2.3% against, and the balance didn't vote. Less than 1% of the stockholders were paid off in cash pursuant to their rights of an appraisal.

The accompanying chart gives the price action of the preferred stock before and after the announcement of the offer. When trading starts in the new securities on a when-issued basis, the old and new tend to reach a parity due to arbitrage. This is illustrated on the chart. The arbitrageurs will sell the new security short and purchase the old. They will cover their short position by delivery of the new securities that they eventually receive in exchange from the old ones. The closeness to parity will depend on the extent of the assurance that the exchange will be consummated.

ILLUSTRATION OF MARKET PRICE ACTION IN AN EXCHANGE OFFER
MARKET PRICE OF 7% PREFERRED



The size of the premium which must be given in the new securities is a matter of judgment and depends on the interest which the company has in making a successful exchange, existing market conditions, nature of the holders who own the old securities and their interest in retaining the old securities, and tax features which may affect the company and the holders.

A company may, and most likely will, elicit the aid of an investment banker at least for advice. Certain types of exchange offers may, in fact, be underwritten. For example, if a company has a high dividend preferred stock outstanding which is callable, it may wish to give the existing preferred stockholders an opportunity to purchase a new lower dividend rate preferred. An underwriting of the exchange will involve having the underwriters agree to purchase any new preferred not exchanged so that the money will be available to call the old preferred.

If your exchange is a complicated one, you may be involved with additional experts in many fields, including accountants, lawyers, tax experts, and even engineers where appraisal of assets and manufacturing processes are important. Thus, exchanges present an intriguing problem which involves pricing securities, evaluating market conditions and knowing the interest of existing holders. Sometimes, the task requires a great deal of ingenuity—the final note, on which we will end this chapter.

*CHAPTER VIII*

# Selling Common Stock

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This chapter presupposes that you are familiar with the general ideas about offering securities; they were described in Chapter VII, "Selling Senior Securities." Selling common stock is much more complicated; consequently, this chapter is not easy. However, if you like finance you will find it interesting.

We will be concerned with the public offering of common stock. Common stock generally does not lend itself to private sale through exemption from registration under the Securities Act of 1933. When private sale of senior securities was discussed, it was pointed out that it is largely the nature of the potential purchasers that governs the exemption, that is, whether they are sufficiently sophisticated to protect themselves. Common stock is generally sold to a large group of individuals rather than institutions alone and, therefore, less opportunity is afforded for the exemption to apply. Private sale of common stock is primarily limited to purchase by a few people, such as the founders of a new company. If, in any way, a common stock offering gets out of that class, it must be registered under the Securities Act and sold only with a prospectus—unless it is exempt from the Act because it is an intrastate transaction.

One of the reasons for the complicated nature of offering common stock publicly is that there are two methods which are quite different: sale through rights to existing stockholders, and direct sale to the public.

Your first big decision concerns which method to use. Before you can resolve this question, it is necessary to understand each method thoroughly. Direct sale is easy, but the rights method is not. Therefore, we will begin by spending considerable time in explaining the rights method. We will also cover underwriters' spread and corporate expenses. We will then review direct offering in a similar way. Only after a complete understanding of the two methods can we attempt to answer the tough question as to whether you should use rights or a direct offering.

These three subjects—rights offerings, direct offerings, and rights *versus* direct—will occupy most of the chapter. Most of the explanation will pertain to financing by companies which already have some stock publicly held, and for which there is a market quotation. Under direct offering, we will say a word about the situation in which, previous to the new issue, there was no publicly-held stock. We will finish with a brief discussion of some of the other subjects with which you should be familiar in offering common stocks.

We will not go into all the steps required in the sale of common stock, such as the proxy statement, filing of the registration statement, writing the prospectus, etc. Many of the ideas on the mechanics of financing that were discussed in the previous chapter still apply.

Our goal in offering common stock is somewhat different from that for senior securities, since we are dealing with the security which stands for ownership. We wish to raise the most amount of money per share of common stock at the least cost combined with the most benefit to the existing owners. It is the latter consideration which differentiates sale of common stock from sale of senior securities. This will become apparent when we get to the comparison of rights and direct offerings.

## OFFERING THROUGH RIGHTS

You undoubtedly know what is meant by offering stock through rights to existing stockholders, but a little review won't do any harm so that we will be on the same track. As an example, we will take a company with 1,000,000 shares of common. The management decides to sell 100,000 new shares through rights to existing stockholders. They are given the right to subscribe to the new stock in proportion to their existing holdings at a price below the market price; in our example, the ratio is 1 new share for each 10 held. This valuable right must be exercised in a certain number of days.

This is a public offering and must be registered with the Securities and Exchange Commission. The procedure in such financing is to send to each stockholder an announcement of the offering, a prospectus describing the company and the terms of the offering, and a warrant to subscribe.

Each stockholder receives one warrant stating the number of rights to which he is entitled: that is, one right for each share of stock he owns. In our example, if a stockholder owned 100 shares, his warrant would show 100 rights. Since the offering of new stock is on the basis of 1 new share for each 10 shares held, then the 100 rights would permit a stockholder to subscribe to 10 new shares. In other words, there is one right for each share of stock outstanding before the new offering.

The warrant states the subscription price, and the day on which the warrant expires.

### *Division of New Shares into Three Groups*

As a result of stockholders' actions, the new shares will fall into one of three categories:

1. *Shares subscribed by original stockholders.* Some stockholders subscribe by signing the warrants and sending them to the subscription agents with a check for the subscription price for the number of shares to which they are entitled.
2. *Shares subscribed by purchasers of rights.* Some stockholders sell their rights through a broker and deliver the warrant so that the purchasers can subscribe.
3. *Shares unsubscribed due to lapsed rights.* Some stockholders fail to do anything and let their rights lapse for various reasons: stockholders may die during the rights period, others may be away from home and not receive their mail, and still others may just forget. The extent of lapsed rights will depend somewhat on the nature of the stockholder list. For example, a company which in the past has been through financial difficulties and reorganization will probably have more stockholders who disregard their rights than a relatively new company which has been prosperous. These unsubscribed shares are sometimes referred to as "tag end."

There is not much information available on the amount of shares represented by categories *1* and *2* above. In compiling results of rights offerings, companies generally do not distinguish between subscriptions by the original stockholders and those who purchase rights.

There will be variation in offerings. For purposes of this chapter, we will use the following figures: 50% of the new offering represented by subscriptions by original stockholders, that is, category *1;* and 47% by purchasers of rights, that is, category *2*. If the rights have a reasonable value, the lapsed rights, or category *3*, generally result in only about 3% of the new offering being unsubscribed. If there is an underwriter, the unsubscribed shares or the "tag end" goes to the underwriter to sell. If there is no underwriter, then the company may do nothing with them and reduce the offering by that amount, or it may arrange to sell them to an underwriting house after the subscription period is over. Tag end shares can also be eliminated through oversubscription, discussed subsequently. In some instances, companies have arranged to offer the unsubscribed shares to employees at the subscription price. Of course, if the market price falls below the subscription price, there is no incentive for anyone to subscribe and the number of lapsed rights correspondingly increases.

Confusion may arise between the number of stockholders and the number of shares represented by these various categories. Basically, we are interested in the number of shares and not the number of stockholders. In discussing rights offering, be careful that someone doesn't mislead you by using stockholder figures rather than shares.

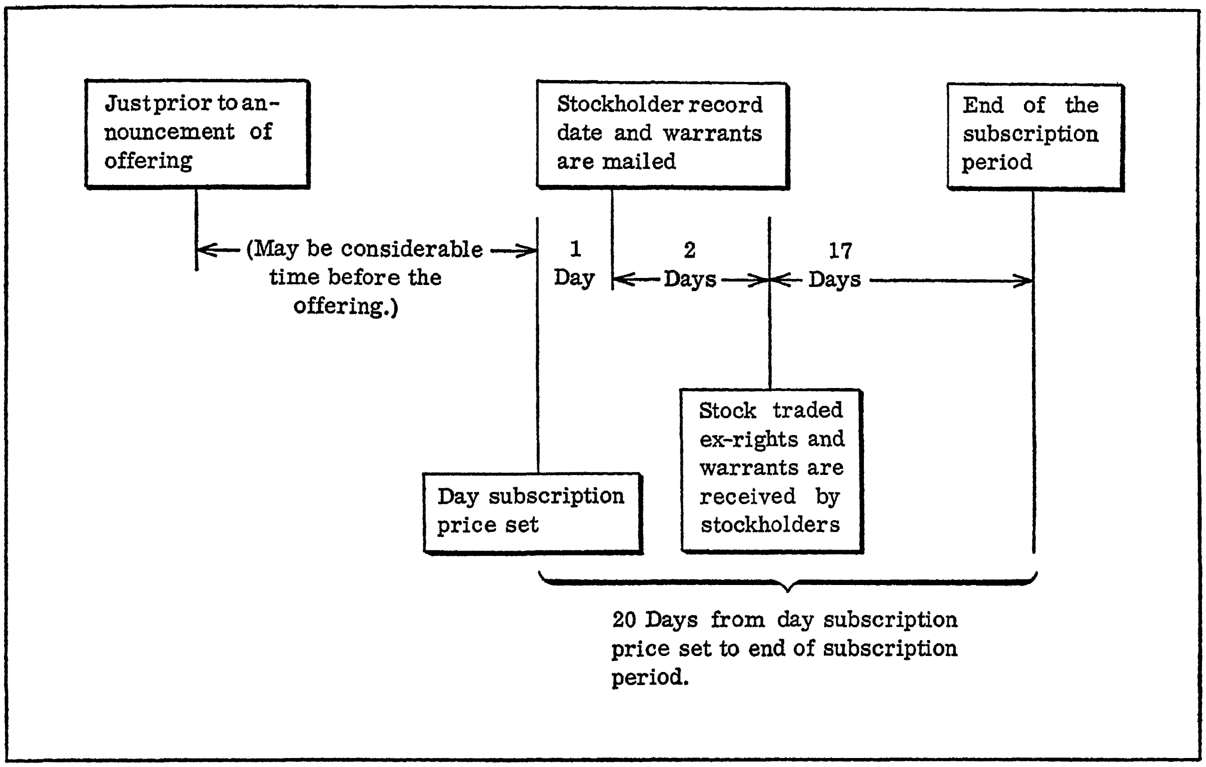
### *The Subscription Period*

One of the important elements in a rights offering is the number of days between the day the company sets the subscription price and the end of the subscription period. It is this period which the company must study in setting the subscription price, and which determines the risks to be allowed for; the shorter the period, the less risk of something happening which might depress the market price of the stock below the subscription price.

Assume that our stock is listed on the New York Stock Exchange. The Exchange has something to say about the procedure in offering to stockholders for listed securities, particularly as to the length of the subscription period. The purpose is to allow enough time to permit stockholders to act. The length of the period will depend on the number of stockholders, their location and the extent of the facilities which the company provides for assisting stockholders to subscribe. Under some circumstances, the New York Stock Exchange will permit a period of 17 days from the day the warrants are received by stockholders to the end of the subscription period. Under special circumstances, where the number of stockholders is relatively small and not unduly scattered, the period may be shorter. The subscription price has to be set before the warrants can be printed and mailed out, and this may take about 3 days. Thus, the total time from the day the subscription price is set to the end of the subscription period may be about 20 days. For very large offerings, where stockholders are scattered throughout the world, a period as long as 55 days has been used.

There are other dates which come into the picture. The stockholder record date establishes the stockholder list for mailing warrants. This may also be the day the registration statement becomes effective. There is a previous date which is important in analyzing a rights offering, and that is the time of the announcement of the offering. The significance of this date will be found in a later explanation.

The sequence of important dates may be better understood in diagram form.


Just prior to announcement of offering
Stockholder record date and warrants are mailed
End of the subscription period
(May be considerable time before the offering.)
1 Day
2 Days
17 Days
Stock traded ex-rights and warrants are received by stockholders
Day subscription price set
20 Days from day subscription price set to end of subscription period.

Trading in the rights will start on a "when issued" basis as soon as the registration statement is effective. Obviously, the subscription price has to be set first in order for the value of the rights to be established. The term "when issued" means just what it implies: the rights have not yet been sent out to stockholders. The New York Stock Exchange fixes the day for listed stocks on which trading is ex-rights, that is, when the stock no longer has the rights attached, usually the second day after the record date. If a stockholder sells his stock after the record date but before the stock is traded ex-rights, then when he receives the rights, he will have to forward them to the purchaser of the stock.

A study of a rights offering has to begin just before the announcement of the proposed new common stock financing, because the market price of the existing stock will generally be affected by the announcement. As our take-off point, we will use one or two days prior to announcement of the offering. Our "countdown" starts here. The day the subscription price is set is our "launching day."

### *Questions to Be Answered in a Rights Offering*

There are three major questions which we will wish to answer:

1. How far should the subscription price be set below the market price?
2. Should the issue be underwritten?
3. If underwritten, how much should you pay the underwriter?

Since a large amount of explanation must follow, it might be of assistance if we gave you a brief answer to the first question at this point.

There is wide range within which a company may decide to set the subscription price below the market price on the day the subscription price is set, from a few percentage points up to 25% and more. In this book, we will call this figure, expressed as a percent or dollar amount, the discount. What course is chosen will depend, among other things, on the amount and ratio of the offering and the type of the common stock. Perhaps the policy most often followed, for a relatively stable type of stock like an electric utility, is to set the subscription price about 7% below the market price for a moderate-sized offering with an offering ratio about 1 for 10. An underwriting would generally be required unless the company wished to take some risk of failure, but the underwriting expense would be small. A corresponding percentage for larger issues of a more volatile type of stock, such as an industrial, may be around 15%. These generalities won't be too helpful for you to use to arrive at a conclusion for your own stock, but the reasons for the wide range in the figures will become apparent as our explanation unfolds. Then you will have sufficient information to assist you in making a decision.

Due to the complicated nature of the subject, we will attack it in two steps: first, with a qualitative explanation, and then a quantitative one. Thus, we will first show what happens, and then we will get down to actual figures.

### *Qualitative Explanation of Rights Offering*

We begin poised just prior to the announcement. In order to bring the picture down out of the clouds, we will use some figures but they should only be viewed as props at this time.

Let us assume that the market price of the outstanding stock is $100 per share. After the new offering is announced there is a tendency for the price to decrease somewhat, relative to the movement of the general securities market, from the time of the announcement to the day the subscription price is set. This is due to the action on the part of potential purchasers of the stock in withholding their orders to buy, in anticipation of lower prices when the effect of the added supply actually takes place. This is called *pre-offering pressure.* We will assume that while the general market for securities remains level, the market price of the stock declines to $99 on the day the subscription price is set due to the pre-offering pressure.

The day arrives on which the subscription price is set. There are 20 days to go before the end of the subscription period. The management faces the difficult task of establishing the subscription price. We will assume that it decides on $92, which is $7 under the market price of $99 on the day the subscription price is set. The management decides to have the issue underwritten and after negotiating with underwriters, a compensation of $1.00 per share is agreed upon. Corporate expenses for printing the prospectus, for legal fees, and so forth, are estimated to be $1.00 per share.

Therefore, the picture, on a per share basis, is as shown in the table below.

The meaning of total underpricing will be explained subsequently.

| | | | |
|---|---|---|---|
| Total Under-Pricing | Market Price of Stock Just Before Announcement of Offering | $100.00 | |
| | Decline in Price Due to Pre-Offering Pressure | 1.00 | |
| | Market Price on Day Subscription Price Set | $ 99.00 | The Discount |
| | Subscription Price | 92.00 | |
| | Underwriters' Compensation | 1.00 | |
| | Corporate Expenses | 1.00 | |
| | Net Proceeds to Company | $ 90.00 | |

*Value of One Right*

We must depart from our general theme long enough to explain how the value of a right is determined. If you are familiar with the formula you can skip this section. A right's value was discussed briefly under arbitrage, but we will cover it briefly here as it applies to our example.

An owner of the rights gets a bargain. A person who has 10 shares gets 10 rights and can subscribe for one share of stock for $92.00, which is worth more in the market. When the subscription is first announced and before the warrants have been mailed to the stockholders so that the stock is with rights, each share of stock has the right still "attached" to it. The market price of the stock then includes the value of one right and will be greater than after ex-rights by the value of the right. Therefore, in order to obtain the value of a right before the stock goes ex-rights, we have to include an allowance for the one right. To do this a "+ 1" is added to the offering ratio in the denominator of the rights formula, as follows:

$$\text{Price of Right before Ex-Rights} = \frac{\text{Market Price of Stock with Right—Subscription Price}}{\text{Offering Ratio} + 1}$$

$$= \frac{\$99 - \$92}{10 + 1}$$

$$= \frac{\$7}{11}$$

$$= \$0.636$$

After the stock has gone ex-rights the market price per share will decrease from $99, by the value of one right, $0.636, to $98.364, or, rounded off, $98.36.

Now that the stock is ex-rights, it is easier to see how the value of a right is determined. A person who has 10 rights can subscribe for one share at $92.00 which is worth $98.36 in the market, or at a $6.36 discount. Since the 10 rights, thus, have a value of $6.36, one right has a value of $0.636. This can be expressed in the simple rights value formula which applies after the stock has gone ex-rights.

$$\text{Price of Right after Ex-Rights} = \frac{\text{Market Price of Stock Ex-Right—Subscription Price}}{\text{Offering Ratio}}$$

$$= \frac{\$98.36 - \$92}{10}$$

$$= \$0.636$$

Note that the only difference in the two formulas is the "+1" added to the offering ratio in the denominator before the stock has gone ex-rights and the market price of the stock includes the right.

You may hear the expression "the Parity Table" when discussing rights offerings. This is merely an equivalent table, showing the mathematical value of the rights based on the formula discussed above for various prices of the stock. Thus, someone interested in the rights can quickly obtain their value for various prices of the stock. A simple table, using our example, would be as shown on the next page.

If a person was not an original stockholder and bought rights in the market in order to subscribe, then he would come out with a purchase price per share equivalent to the market value. For example, 10 rights at $0.636 per right would cost $6.36. If he used these rights to subscribe at $92.00 per share, the total cost would be $6.36 plus $92, or $98.36, which is the parity price of the stock in the table below when the rights are worth $0.636.

| *Price of Stock Ex-Rights* | *Equivalent Rights Value* |
|---|---|
| $100.00 | $0.800 |
| 99.00 | 0.700 |
| 98.36 | 0.636 |
| 98.00 | 0.600 |
| 97.00 | 0.500 |

As discussed under the subject of arbitrage, there generally is a spread between these two equivalents, because of expenses involved in purchases of rights, transfer taxes, and so on.

### *Factors Affecting Decline in Market Price*

Now let's go back and see what factors had to be weighed in setting the subscription price. The principal problem is estimating the possible risk of the market price of the stock declining to or below the subscription price during the offering period so that the rights would be worthless. For example, if the stock declined below $92 per share, the rights would have no value, and no stockholder in his right mind would subscribe, since he could purchase the existing stock in the market at less than $92.[1] If the stock stayed below $92 for the entire subscription period then, at the end, the underwriters would have to pay the company the $92 per share, less the underwriters' compensation of $1.00 per share, or a net of $91.00. They would own the stock. The extent of their loss would depend on the price at which they could sell the stock within a relatively short time. Ordinarily, they would not wish to hold it very long and gamble on the market.

Starting from just before the announcement of the offering, the factors which may cause a decline in the market price of the stock may be grouped under the headings given below. The capital letters next to each are for identification purposes in a chart which follows.

*P—Pre-offering pressure*—We have already noted the decline in price due to pre-offering pressure from $100 per share to $99 per share from the day the company announced the offering to the day on which the company set the subscription. The extent of this decline will be affected by the same factors to be discussed under subscription period pressure.

*Drop in price due to stock going ex-rights*—Purely as a matter of mathematics, the stock will drop in price the value of one right on the day the stock goes ex-rights. In our example, a right was worth $0.64; so now the ex-rights price of the stock is $98.36 per share. We will not give this mechanical drop in the market price any symbol.

*S—Subscription period pressure*—When the stockholders who do not wish to subscribe sell their rights, the market value of the rights tends to decline, but the price of the stock is kept in parity with the rights value due to action by the arbitrageurs, as explained in Chapter VI. This is the way the added supply of the stock acting through the rights has a depressing effect on the market during the subscription period. The extent of the decline will depend on:

1. All the circumstances surrounding the new offering, including the size of offering, the offering ratio, and such offering features as oversubscription, dealer compensation, etc. These latter points will be explained at the end of the chapter. The larger the issue, other things being equal, the greater will be the pressure.
2. Everything which affects the quality and outlook for the company and its stock.

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[1] Actually, even if the market price of the stock is slightly below $92, it might pay a purchaser to subscribe rather than buy stock in the open market, because in the latter transaction he would have to pay a brokerage fee. This is a minor qualification.

A high quality stock with favorable outlook will tend to resist pressure more than a poor quality stock with an unfavorable outlook.

3. The nature of the existing market for the company's common stock, including whether it is closely held, the type of holders, whether it is listed or not listed. A broad active interest will tend to reduce the effect of pressure.
4. The general condition of the securities market, including its relative level, and the general interest of investors toward the purchase of new issues. The condition of the securities market is one of the most important factors affecting pressure. An active market tends to reduce pressure, and, in fact, in some "boiling" bull markets no pressure may appear whatsoever.
5. Special advantages which may exist for holders of the rights as compared to the purchase of the outstanding stock. This pertains primarily to the matter of margin requirements as established by the Board of Governors of the Federal Reserve System for listed stocks. There have been times when persons who subscribe could borrow from banks on margin up to 75% of the subscription price for a certain period of time, whereas they could only borrow 10% of the market price if they purchased the outstanding stock. The reason for the more liberal treatment accorded in a rights offering is to assist stockholders in their effort to maintain their position in the company. Banks' willingness to lend, of course, may also have a bearing on the situation.

Another factor which is included as part of this heading, "S—Subscription period pressure," is the tendency for the stock to decline due to the investors' appraisal of the immediate dilution effect on earnings per share caused by the added number of shares. The offering ratio has an important effect on this element. The maximum dilution would be on the assumption that the new capital earned nothing and that the earnings per share were reduced proportionately by the new shares. If the new capital were to be used for a project which would quite definitely increase the earnings per share, then there might be a tendency for the stock to increase in price. This, however, would be unlikely. The actual extent of dilution will depend on how quickly and to what extent investors expect earnings to materialize on the new capital.

Therefore, lumped together under this heading, "S—Subscription period pressure," are the effect of the added supply and the temporary dilution effect on earnings due to the greater number of shares.

The stockholders who sell their rights are interested in the extent of the pressure whenever they sell their rights, but from the point of view of our immediate analysis, the company is more interested in the pressure towards the end of the subscription period, which we will consider as being the last five days of the subscription period. The reason for the emphasis on the last five days is that most subscriptions are made during that period and the success or failure of an offering will depend largely on what happens then to the market for the stock. Most subscriptions are made in the last few days because, as previously explained, a stockholder would be foolish to exercise his rights if the market price of the stock falls below the subscription price. It makes sense for stockholders to wait until the end of the subscription period to subscribe in order to see what will happen to the market price. Actually, it is primarily the professionals, that is, the brokers and dealers, who wait until the last few days. They handle a large volume of rights. They have an added reason to wait until the end. They may use bank loans to finance their subscriptions, and they will not wish to pay interest any longer than necessary. The small stockholders can't be bothered with such close calculations. From the point of view of the risk factor throughout our study of rights offerings, we will take the last five days as the most important part of the subscription period. Of course, it should be realized that if the market price of the stock does go below the subscription price in the first part of the subscription period, it will undoubtedly reduce the number of shares subscribed to some extent.

In our example, let us suppose that the subscription period pressure will cause the price of the stock to decline to $96.50 during the last five days.

*A—Adverse developments for company*—The next factor is the possibility that the company may encounter some adverse development from the time the subscription price is set to the end of the subscription period. For example, if a small oil company struck a dry well in one of its best areas during the offering period, the price of the stock might be depressed. As another example, suppose that during an offering by a company, one of its important products, say, a vaccine had been found to be defective.

The likelihood of an adverse development occurring during an offering is relatively slim, because a company would not plan an offering if there were a likelihood of such an occurrence. Nevertheless, it must be kept in mind as a remote possibility, depending on the nature of the company's business. In our example, while we will note the potential hazard, we will make no specific allowance for it because its possibility of occurrence is too remote. Therefore, we still only have our stock down to $96.50.

Of course, some favorable development may occur for the company during the subscription period and cause the stock to advance in price. If it does go up, so much the better, but in deciding where to set the subscription price, our efforts are directed at determining the danger of a decline, rather than the possibility of an upward as well as a downward movement.

*R—Allowance for rights value; M—Allowance for market break*—We now have two elements which are quite distinct but which can be considered together. Let us start with the first one listed above, *R—Allowance for rights value.*

When you offer stock through rights, there are many stockholders who will wish to sell their rights. They are directly interested in the market value of their rights. If you set the subscription price so close to the market that the rights are worth only a few cents, stockholders will find that the brokerage charges and transfer taxes to sell the rights may be more than the value of the rights. This is bound to cause annoyance. Therefore, the subscription price should be established sufficiently below the market, after allowing for factors already discussed, to make the rights have some value.

A minimum rights value might be about ⅔ of 1% of the value of the stock for a 1-for-10 offering. For a stock selling at $25, this would mean a rights value of 17¢ per right, and for a stock selling at $100, it would mean 67¢ per right. If a person owned 100 shares of stock selling at $25 per share, the 100 rights at 17¢ per right would be worth $17.00. For a stock listed on the New York Stock Exchange, the brokerage charge and transfer tax[2] to sell them would amount to about $1.06, so that he would net $15.94 from sale of the rights.

The offering ratio will have an important effect on rights value. A subscription price which would produce a rights value of 17¢ per right on a 1-for-10 offering for a $25 stock, would result in a rights value of only 9¢ per right for a 1-for-20 offering, and 34¢ for a 1-for-5 offering. Actually, there is no set rule for a minimum rights value. Keep in mind that it should not be so small as to cause stockholder annoyance; rather, it should be sufficient to promote stockholder good will.

In figuring an appropriate allowance for rights value, you should take into account that the stock may be depressed somewhat due to subscription period pressure and that the estimated rights value should be *after* this allowance. Pressure always causes a downward tendency in price and not, as in the case of market break discussed below, either upward or downward. In our example, the rights value is 64¢ before the effect of our assumed subscription period pressure, and 45¢ after making full allowance for the maximum in the last five days.

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[2] The Federal transfer tax is 4¢ per $100, or major fraction thereof, of the money involved in the sale, but not more than 8¢ per share.

The other item listed above in this dual heading is *M—Allowance for market break*, a most important element. This pertains to the action of the general market for common stocks, which may be level, up or down. Since stock prices represent relative values, individual stocks tend to move up and down with the general market unless there is some special development which would cause them to move counter thereto. In other words, if all stocks go down, they will have a depressing effect on our stock, and if they go up, there will be a buoying effect.

How will this affect our allowance for rights value? Basically not at all, because there is an equal chance that the rights value will be enhanced by a market rise as there is for them to be depressed by a market break. There is an equal chance that the stockholders will benefit or be hurt. True, a market break could reduce the value of the rights to a nominal figure or wipe out that value, but this is one of the inherent risks in rights offerings which the stockholders must assume. And, again, the rights have an equal chance of appreciation. Of course, a company may wish to set the subscription price so low as to assure a good rights value, no matter what happens, but this is another matter which we will cover more fully when we get into quantitative analysis.

Why worry about market break at all? In evaluating the risk of having an unsuccessful offering, it is one of the most important elements, because it might push the price of the stock below the subscription price. In such an eventuality, subscriptions would not take place and the company would not get its money unless the financing were underwritten. If it were underwritten, it would be the underwriters who would take the beating. So we have to evaluate the possibility of market break carefully. But how?

What we are interested in determining is the possibility of a general market break occurring in a 20-day period and the extent of that possibility. Remember, we are most interested in the last five days of the subscription period, because that is when most subscriptions take place. This can be determined from an analysis of the action of the market price of a company's stock during many 20-day periods over a number of years.

Thus, market break is one of the factors which will determine how far the subscription price is set below the market, whether the issue should be underwritten and, if so, the risk which the underwriters will take as well as the pay they should receive.

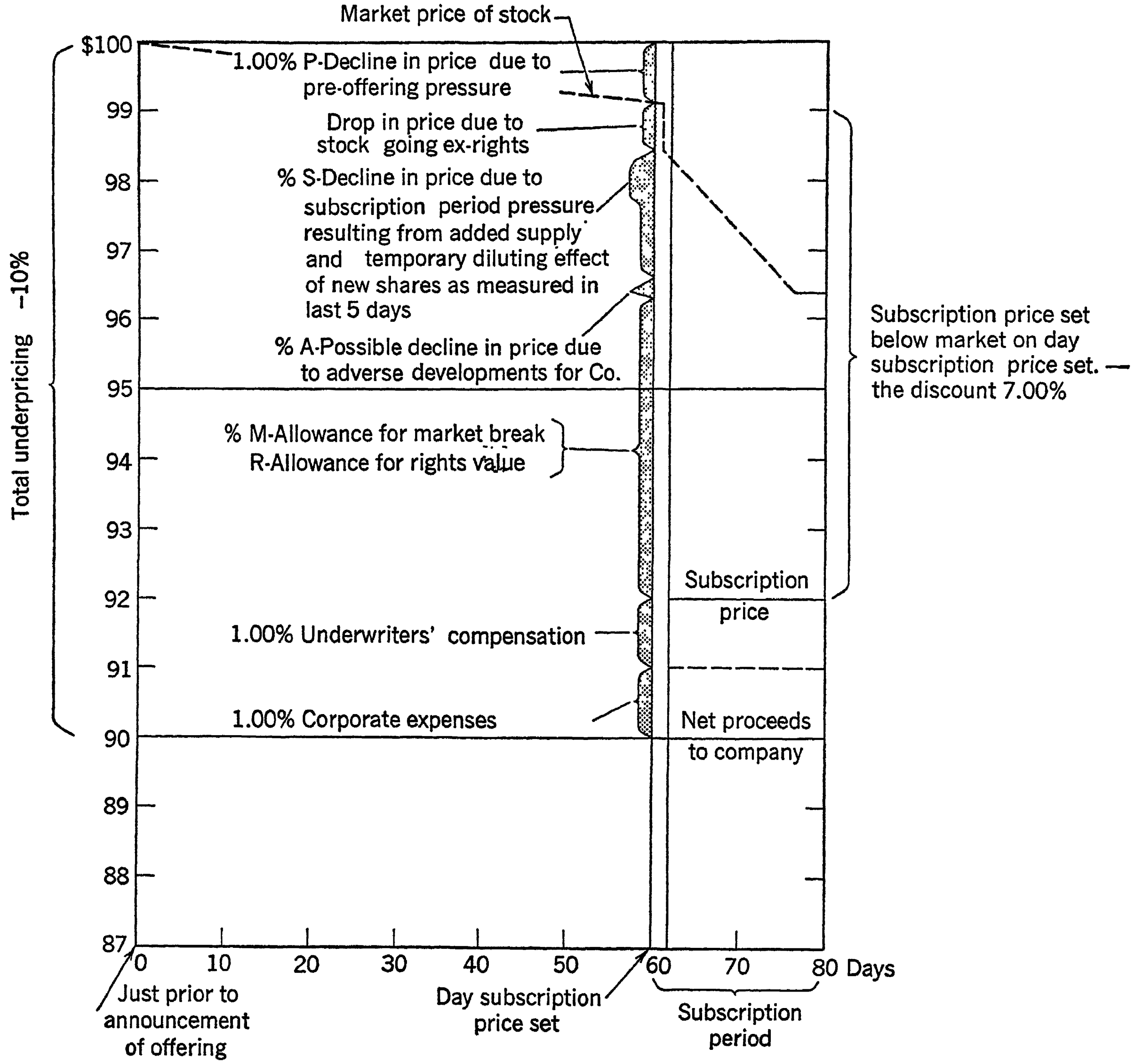
This is enough for the qualitative explanation of market break at this stage.

*Underwriters' compensation; Corporate expenses*—The company will wish to know how much it will receive net per share after all allowances and expenses. Hence, it must deduct the underwriters' compensation, if any, and corporate expenses from the subscription price in order to get the net proceeds per share.

*Total underpricing*—The expression, total underpricing, which is perhaps not very descriptive, has grown up to represent the total of all the additive items discussed above. It is a factor which must be allowed for in determining the cost rate for common equity in Cost-of-Capital, which is covered in Chapter X. It is not to be confused with the discount, that is, the amount by which the subscription price is set below the market on the day the subscription price is set. Total underpricing includes three additional items: pre-offering pressure, underwriters' compensation, if any, and corporate expenses.

*A review of qualitative explanation*—Don't go any further until you understand what has already been said. Otherwise, as we proceed the subject will become more difficult. For a quick review, look at the chart immediately below. It is based on the figures which were used for illustrative purposes on page 249. It presupposes that the general stock market is level during the offering. Reread the previous explanation on any point you don't understand.

Rights Common Stock Offering Underpricing Illustration
(Assuming a Level General Stock Market)



*Actual market action in rights offering, not a regular pattern*—If a rights offering always followed the pattern of the explanation given above, the professional security traders would make a fortune. It would be like shooting fish in a barrel. They would merely go short stock at the beginning of an offering and make money by covering their short position when the stock had gone off due to pressure. The professionals would like to do just that, but the pattern is almost never exactly "normal." Furthermore, the professionals by their own actions may change the pattern of pressure. Occasionally, they make some bad judgments, known only to themselves, and the consequent market effect is hard for the outsider to understand. Therefore, don't expect a consistent pattern. There are many other reasons which will confuse the actual results, as we will see shortly. You may say: "And now you tell me that there are even more complications to come." Well, if you had been told before, you wouldn't have read this far. Our task is not quite as hopeless as it may sound. This is merely a warning to keep you from expecting precision. We can make estimates within some reasonable degree, and we are, in fact, forced to do so in order to determine answers to our three major questions: Where to set the subscription price, whether to use an underwriter and, if one is used, how much to pay him. So let's continue, being ready to use a good pinch of judgment on the way.

### *Separation of Pressure*

The principal operation we must perform is separating out the effects of pressure. Pressure may be defined as the decrease in the market price of a stock caused by the new issue, as compared with how the market price would have acted if there had been no new offering.

As previously stated, the market price of a stock will have a tendency to go up or down as a result of a change in the general level of other stocks so that the particular stock is relatively more or less attractive. We can eliminate the effect of the change in the general level of the stock market by the use of an index of comparable types of stocks. In making this elimination, we must start our study just before the announcement of the offering, because pre-offering pressure may begin to take effect as soon as the announcement is made. To illustrate the separation of pressure from the effect of a change in the general level of other stocks, we will take an actual offering of about $329,000,000 of common stock by a large company. The offering ratio was 1-for-20 and the subscription period was from February 9 to March 7. The subscription price was $75 per share. Shown in the chart on page 256 are the market price of the stock (plus the value of one right during the subscription period) and the Dow-Jones Industrial Stock Average, both as index numbers with 100 as the starting point just prior to the formal announcement of the offering. The Dow-Jones Average is used to measure the upward and downward movement of the general market. If it goes down, that is the market break we have to worry about. Pressure is measured as the difference between the Dow-Jones index and the index for the company's stock. The results are given in the chart but may be summarized as follows:

| | |
|---|---|
| Pressure from two days prior to announcement of offering:[1] | |
| On day subscription price set | (3.37)% |
| Maximum pressure during subscription period | 4.77% |
| Maximum pressure during last five days of subscription period | 4.76% |
| Pressure from day subscription price set:[2] | |
| Maximum pressure during subscription period | 8.14% |
| Maximum pressure during last 5 days of subscription period | 8.13% |

If you understand what is meant by pressure, you undoubtedly let out a howl when you saw the negative pressure on the day the subscription price was set. How can there be negative pressure? You have a right to an explanation, but we will include it with other reasons why our pressure figures may not be very accurate. They are as follows:

1. Our starting date probably understates pressure. It is seldom that we have a clear-cut date. References may be made by a company about new financing long before the press release with the details about the issue. Furthermore, the well-informed analysts may, as a result of knowing the company's financial needs, make their own estimates of a forthcoming issue. Therefore, generally all

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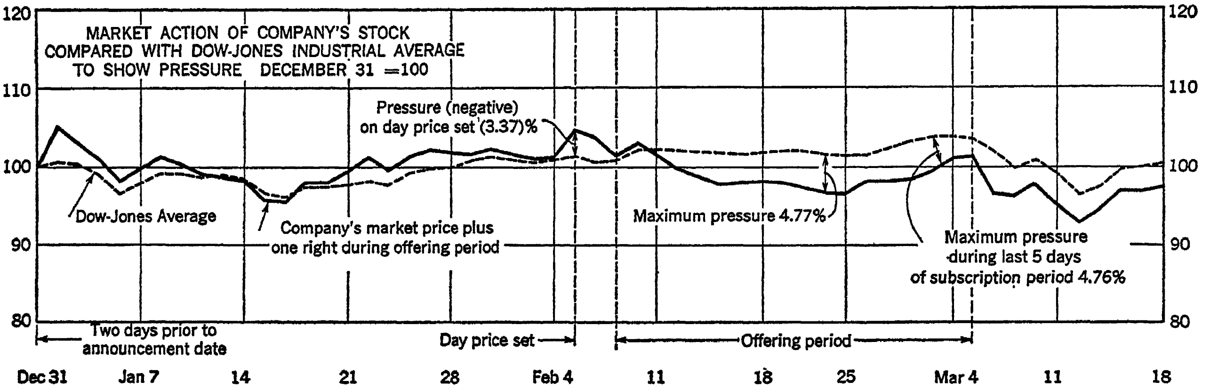
[1] Parentheses signify negative pressure.

[2] Derived by subtracting the pressure on the day the subscription price set. In this case, since the pressure at that point is negative, it is added.

pre-offering pressure cannot be determined by starting from the formal announcement of the financing. But we must start somewhere. As a rule of thumb, we take one or two days before the formal announcement when it is not more than about two or three months before the offering itself. When the announcement is more than about three months prior, this system may not be used, because then the time interval is so long that something may happen to the company, such as a new earnings report, which may affect the price of the stock much more than pre-offering pressure and which cannot be isolated. In such a situation, we use an arbitrary starting date two months before the offering.[3] If the formal announcement is closer than two months, we still use our two months arbitrary starting point, on the assumption that undoubtedly the news has already leaked out some time ago.



2. Our tool, the Dow-Jones Average, may not be very good for the purpose. It may be influenced in an up or downward movement by many factors other than just the general supply and demand for stocks. For example, the Average includes metal stocks and a change in metal prices might make those stocks move counter to the rest of the market. However, unless we were to construct a special average, which would be quite laborious and of doubtful additional value, the Dow-Jones Industrial Average is the best available for our immediate purpose. If we were studying another type of stock such as a utility, we would select another average with stocks of companies as nearly like our company as possible. Be sure to interpret the results in light of the possible error due to the tool used.
3. Aside from the effect of the general market movement of stocks and the pressure of a new offering, the market price of a stock may be influenced by adverse or favorable developments affecting the earnings of the company either directly or indirectly. For example, suppose some good or bad news about the company came out after the announcement of the financing; then the stock would react and this would cover up or exaggerate pressure figures, depending on whether the news was favorable or unfavorable. All we can do in this respect is to note

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[3] Some experts strongly criticize the use of such an artificial date and in their studies make it a point to use a more comprehensive period, which should be determined by actual studies as to when pressure was in fact first reflected. Their criticism is a valid one and the dangers of understating pressure by using such an arbitrary starting date should be fully recognized. This particularly applies in determining a proper cost rate for common stock for Cost-of-Capital purposes, as discussed in Chapter X.

any such news which would tend to throw off the results of our analysis of pressure.

4. During the short run the price of a stock may hop up or down due to temporary imbalance in the longer run supply and demand for the stock. This may make some peculiar day-to-day price fluctuations. For example, as previously mentioned, the traders and arbitrageurs in a rights offering are continuously trying to guess the future market movement of a stock. If they guess wrong and have to cover their position, they may cause a temporary swing which will be hard for an outsider to understand.

We referred to the negative pressure in our example on the day the subscription price was set without explaining what is meant by it. Theoretically, and in fact quite practically, there is little reason for negative pressure, because pressure is the result of added supply and, according to the law of supply and demand, with an added supply the price should go down. Then why the apparent negative pressure? Perhaps you have already caught on. It may be caused by any one of the four factors mentioned above. There may be one additional reason. At times, as previously discussed, there may be a special advantage of margin requirements attaching to rights offerings and this may tend to counteract the pressure.

Therefore, in our study of pressure we must not expect precision, and in any particular offering there may be other influences which throw off our results. The figures must be interpreted with this in mind, and this is where that good pinch of judgment is required. With all these qualifications, you may feel like throwing up your hands and saying a few unprintable words. Do so, but then accept the fact that pressure is an important item in a stock offering; its effect can be observed; and while its pattern is very erratic and unpredictable and at times unexplainable, we can get some idea of its general magnitude and we must allow for it in a rights offering. With these cautioning words, let's turn to some quantitative figures. We need to have them on pre-offering pressure to see how much the stock has gone off before the subscription price is set, and we have to make some estimate of subscription period pressure in order to decide where to set the subscription price.

Now we will assess the magnitude of these elements which we have described.

### *Quantitative Explanation of Rights Offering*

*P—Pre-offering pressure; S—subscription period pressure*—See on pg. 258 figures from actual offerings by four large industrial companies and 22 electric utility companies. The offerings were generally successful with high subscription percentages. When you look at them, keep in mind the previous comments on possible errors that may occur in measuring pressure.

These observations may be made:

1. The ranges in pressures are not necessarily for the same company for both pre-offering and subscription period pressure; therefore, they are not additive. As explained in the footnote, there may be factors other than pressure to account for the large maximums and minimums.
2. The offerings by the four industrial companies are very large. The large size tends to increase pressure. On the other hand, these companies are well known to a broad group of investors and there is wide demand for their stocks. There would be a tendency for greater pressure for less well-known companies. Thus, their large size was offset to some extent by the character of the companies.
3. The electric utilities, which represent moderate-sized offerings and are more stable types of stocks than industrials, showed less pressure on the average. Note the wide range in pressures. Sixteen of the utility issues were underwritten and six not underwritten.

Pressure in Rights Offerings

| | *Amount of Offering (000's omitted)* | *Offering Ratio* | *Discount % Subscription Price Set under Market Price on Day Price Set* | *Pressure on Day Subscription Price Set. From 2 Days Prior to Announcement* | *Maximum Pressure during Last 5 Days of Subscription Period. From Day Subscription Price Set* |
|---|---|---|---|---|---|
| *4 Industrials* | | | | | |
| 1955-1957 Average | $226,000 | 1-16 | 18.9% | 2.6% | 5.9% |
| Range | | | | | |
| Maximum | 329,000 | 1-5 | 25.8 | 6.8 | 8.1 |
| Minimum | 87,000 | 1-30 | 14.2 | (3.4)[1] | 3.2 |
| *22 Electric Utilities* | | | | | |
| 1953-1957 Average | 14,000 | 1 for 10 | 8.1 | 1.4% | 2.3% |
| Range | | | | | |
| Maximum | 42,000 | 1 for 7 | 15.3 | 10.2 | 8.2 |
| Minimum | 1,000 | 1 for 20 | 4.5 | (11.8)[1] | (3.9)[1] |

[1] Represents negative pressure. This is caused by the fact that the index used to eliminate general market fluctuations is not exactly suitable for the purpose and/or because of some favorable development affecting the particular stock at that time; and/or there was some unusual buying unrelated to the new offering. Some of the maximum positive pressures may be due to similar causes in the opposite direction.

Can we come to any conclusion regarding pressure figures which you can use for your offering? We might think in terms of the average figures shown above, having in mind the wide range that may occur and that the pressure pattern depends on all the circumstances surrounding an issue that we discussed previously. Before a company offers stock through rights, it may wish to study new offerings of a comparable nature by other companies and, of course, any previous offerings by the company itself.

*M—Market break*—In deciding on how far to set the subscription price below the market, the next factor to evaluate is market break. We will use the Dow-Jones Industrial Average[4] as our guide for the performance of an industrial stock in a market break, although, of course, each individual stock will react differently.

The chart on page 259 is for illustrative purposes and shows the period in 1955 when the greatest break occurred in the years 1951-1959 inclusive, from the first day of the 20-day period[5] to the lowest point reached in the final five days. The chart shows a decline of 10.0% from September 23 to October 12. This figure should be considered in relationship to the odds of a break that large occurring. In 1955, there were 253 20-day periods, excluding holidays and weekends. The decline from the first day to the greatest break in the final five days for each of these 20-day periods in that year was as shown in the first table on page 259.

The next largest break in 1955 was 9.9%. In 96% of the 20-day periods, the break was less than 5%. A company setting the subscription price on the first day of any of the 253 twenty-day periods in 1955 would have to have been very unlucky to hit 4% of the periods when the break was 5% or greater. In the year 1955 there was a general upward market movement, and a more thorough analysis of the possibility of the occurrence of different-sized breaks would require a study over a longer period of time. Then we would have statistics on which to play the odds.

---

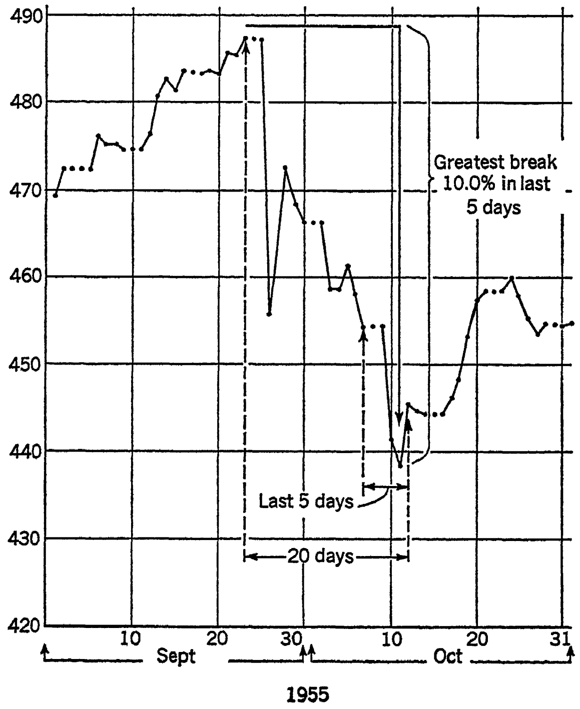
[4] *Stocks included in the Average*—January 4, 1960

Allied Chemical
Aluminum Co. (Amer.)
American Can
Am. Tel. & Tel.
Am. Tobacco
Anaconda
Bethlehem Steel
Chrysler
Du Pont
Eastman Kodak
General Electric
General Foods
General Motors
Goodyear
Int. Harvester
Inter. Nickel
Intl. Paper
Johns Manville
Owens Ill. Glass
Procter & Gamble
Sears Roebuck
St'd Oil of Cal.
St'd Oil of N.J.
Swift
Texaco Inc.
Union Carbide
United Aircraft
U. S. Steel
Westinghouse Elec.
Woolworth

[5] In figuring a 20-day period, holidays and weekends were counted. When the last day fell on a holiday or weekend, the period was extended to the next day on which stocks were traded.

| *% Market Decline* | *Number of 20-Day Periods* | *% of Cases Non-Cum.* | *% of Cases Cumulative* |
|---|---|---|---|
| No decline | 152 | 64% | 64% |
| Less than 1% | 28 | 12 | 76 |
| 1% up to 2% | 18 | 7 | 83 |
| 2% up to 3% | 16 | 6 | 89 |
| 3% up to 4% | 5 | 2 | 91 |
| 4% up to 5% | 12 | 5 | 96 |
| 5% up to 6% | 3 | 1 | 97 |
| 6% up to 7% | 2 | 1 | 98 |
| 7% up to 8% | 0 | — | — |
| 8% up to 9% | 0 | — | — |
| 9% up to 10% | 2 | 1 | 99 |
| 10% up to 11% | 1 | 1 | 100 |
| Total | 239 | 100% | |

MARKET BREAK RISK FOR RIGHTS OFFERINGS ILLUSTRATED BY DOW-JONES INDUSTRIAL AVERAGE FOR THE 20-DAY PERIOD WITH THE GREATEST BREAK IN THE YEARS 1951-1959



The maximum breaks in the last five days in a 20-day period in each year from 1951 to 1959, inclusive, were as follows:

| | *Starting Date* | |
|---|---|---|
| 1951 | October 8 | 6.0% |
| 1952 | February 2 | 5.1% |
| 1953 | July 13 | 6.3% |
| 1954 | August 16 | 3.9% |
| 1955 | September 23 | 10.0% |
| 1956 | May 4 | 9.2% |
| 1957 | October 3 | 9.9% |
| 1958 | February 4 | 4.0% |
| 1959 | August 31 | 5.8% |

In this entire period, there were over 2,300 20-day periods;[6] so it can be seen that the chances of breaks occurring as large as the maximums in each year is relatively slim.

A company should make such a study of its own stock to see how it reacts to market breaks. In the study, allowance must be made for the fact that much of a stock's movements may be due to favorable or adverse developments for the company. We are not now interested in such movements. It is impossible to isolate them but they must be weighed in interpreting the results of a market break study of a single stock.

### *Setting the Subscription Price*

With these ideas of how a stock might react during an offering, we can get down to the problem of setting the subscription price. On the day that we face this problem, we already will have observed how much the stock has reacted due to pre-offering pressure. A brief review of the other factors we will have to weigh may be worthwhile: we will have to estimate how much further the stock may go off due to subscription period pressure in the last five days of the subscription period. We will wish the rights to have some value. We will have to consider the danger of a break in

[6] In 1951 and part of 1952, the New York Stock Exchange had a 6-day work week which has been taken into account in the above computations.

the general market driving the price of the stock down during the last five days of the subscription period. Having these factors in mind, we may group offerings into four general categories, based on the percentage by which the subscription price is set below the market, depending on the type of offering.

1. *Subscription price close to market.* Set the subscription price close to the market on the day the subscription price is set and have the issue underwritten so that the underwriters will take the risk.

This has some definite disadvantages. The rights will be relatively worthless, and the stockholders may be annoyed as a result. Furthermore, the underwriters would be taking a substantial risk and their spread would be large.

This approach would seem to defeat the idea of a rights offering. An offering generally falls into this category if the subscription price is set 6% or less below the market for a moderate-sized issue of a stable type of stock. For a larger, less stable type of stock, the percentage would be higher.

2. *Subscription price moderately below market, with some risk remaining.* Set the subscription price sufficiently low to take care of average pressure, provide a reasonable rights value and protection against all but the most extreme market breaks.

In this situation, the company can either use an underwriter and pay a modest spread, because the risk is small, or use no underwriter and assume the risk that if unusual circumstances are encountered, the offering might not be successful. If a company is raising capital regularly through the sale of common stock, it may take the risk that sometime an offering would not be successful. Then it would have to start the deal over again with a lower subscription price. However, if a company only sells common stock occasionally, it will probably not wish to take the risk of an unsuccessful issue and will be more inclined to use an underwriter.

If the subscription price is set at about 7% below the market,[7] for a relatively stable stock such as an electric utility, and the offering is moderate-sized, then the offering falls in this category. But for a very large issue, and for a less stable stock, the figure might have to be around 15%. It is this category that the management of a company will probably have in mind.

3. *Subscription price sufficiently low to absorb practically all risk.* Set the subscription price so low that there would be practically no possibility of the price declining below the subscription price, and dispense with an underwriter. Depending on the size of the issue, the nature of the stock, etc., the range in discount for this category would be between about 10% for a stable stock to perhaps as much as 20% for a larger issue and for a less stable stock.

4. *Subscription price so low as to include a stock dividend.* Set the subscription price so low that all of the factors which might cause a decline in the price below the subscription price are more than taken care of. In such a situation, the company, in effect, is including a stock dividend with the offering. There is no harm in such a policy, but it is not generally used unless there is some special reason for doing so. More shares than necessary have to be sold at the reduced subscription price in order to raise a given amount of capital; there is added dilution.

A company will generally wish to make its choice between categories 2 and *3* with greater preference for category 2.

You may feel that the above ranges of percentage figures, for the amount which the subscription price should be set below the market, are so broad as to be of little help. However, that is about all that can be done with generalizations. They should serve the purpose of giving you some sense of the picture. Each stock will have to be evaluated by itself. In the previous discussion on pressure, rights value and market break, you have some figures on which to begin your thinking and some suggestions as to how you might study your own stock and other comparable issues in order to form a background for your decision.

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[7] The three other elements of total underpricing—pre-offering pressure, underwriters' spread, and expenses—would result in a figure of about 10% for total underpricing for Cost-of-Capital purposes for a relatively stable type of stock. This is discussed in Chapter X.

In a Securities and Exchange Commission study of 57 common stock offerings in 1955,[8] the subscription price was set below the market as follows:

| *Percentage of Total Issues* | *Subscription Price Set below Market* |
|---|---|
| 20% | 5% or Less |
| 30 | More than 5% and up to and including 10% |
| 50 | More than 10% |
| 100% | |

## USE OF UNDERWRITER

When you establish the amount by which you will set the subscription price below the market, you will simultaneously decide that you are willing to take whatever risk exists; otherwise, you will decide to use an underwriter as insurance. Generally, in the industrial field, an underwriter is used. In the utility field an underwriter is sometimes dispensed with. For example, of the 20 issues of rights offerings of common stock of $2,000,000 and over in 1959, 17 were underwritten and 3 were not.

If your decision is to use an underwriter, you will have to decide whether it should be on a negotiated basis or a competitive basis. Even to raise such a question is almost sacrilegious to the underwriting fraternity. They are unanimously opposed to competitive bidding for stocks. No industrial companies use competitive bidding. In the field of regulated companies generally, only those required to do so rely on competitive bidding. For example, in the electric utility field, in 1959, of the 17 issues of $2,000,000 or over offered by rights which were underwritten, 12 were done on a negotiated basis and 5 competitively. If all you want from your underwriting is the insurance part of that function and yours is a well-known standard type of stock, competitive bidding will undoubtedly perform satisfactorily. However, if you wish some further assistance in managing your offering, you will use the negotiated method.

When you come to negotiating with underwriters, you will have to decide how much to pay them and in what form. You will be like a "babe in the woods" if you haven't done much financing or haven't made a thorough study of the information that is available to you.

Do the underwriters make the same studies as described above? No. They arrive at their decision as to how much they should be paid by looking at the over-all effect of the numerous items mentioned, having had firsthand experience with many issues under varied circumstances. The above methods are good tools for you and the only ones available. When you sit down to talk to your underwriter, you should have an idea of what you are trying to accomplish and the risks involved; otherwise, you will have to delegate your authority to determine your company's financial policy to someone else. Don't misunderstand me! You should rely heavily on your underwriter's advice; he knows much more about markets and many other things about offering securities than you. However, this does not mean that you should turn over the job of setting his compensation to him "carte blanche" any more than you would do with any other expert. Nor should he expect you to do so.

The principal consideration in determining the amount to pay the underwriters, as far as the risk factor is concerned, is the extent of the danger of the market price of the stock declining below the subscription price. This will depend on all factors surrounding the offering and on how far the subscription price is set under the market. Other things being equal, the risk decreases as the discount of the subscription price below the market price is increased. Remember that there are three factors which may cause a decline after the subscription price is set: pressure, market break and possible adverse developments for the company. If you read your underwriting agreement carefully, you should realize that the underwriters do not assume responsibility for the last risk. Furthermore, underwriting agreements may have an "out" if the market turns so badly that the issue cannot be sold. Therefore, in figuring the risk which you are paying for, don't assume that it is all the possible risk. Some general figures on underwriters' compensation and also expenses for rights offering, as published by the Securities and Exchange Commission, follow.[9] They are primarily of interest to give some idea of the effect of size of offering and type of industry. The underwriting spread will vary depending on the market conditions. Therefore, in obtaining an estimate for a proposed offering, you will wish to consider recent offerings of a comparable nature.

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[8] *Cost of Flotation of Corporate Securities 1951-1955,* Securities and Exchange Commission, Washington (25) D. C., June, 1957, page 23.

FINANCING COSTS

COMMON STOCK OFFERINGS THROUGH RIGHTS
1955

CLASSIFIED BY SIZE OF ISSUE AND INDUSTRY OF ISSUER
(Costs as Percentage of Proceeds)

| *Size of Issue (\$ millions)* | *No. of Issues* | *Total Cost* | *Underwriters' Compensation* | *Other Expenses*[1] |
|---|---|---|---|---|
| | | *Manufacturing* | | |
| Under 1.0 | 3 | 8.17% | 5.44% | 2.74% |
| 1.0- 4.9 | 6 | 6.21 | 4.53 | 1.68 |
| 5.0- 9.9 | 3 | 3.19 | 2.38 | 0.81 |
| 10.0-19.9 | 3 | 2.96 | 2.24 | 0.72 |
| 20.0 and over | 2 | 1.65 | 1.28 | 0.38 |
| Total | 17 | | | |
| | | *Public Utilities (incl. Communication)* | | |
| Under 1.0 | 0 | — | — | — |
| 1.0- 4.9 | 7 | 4.30% | 2.71% | 1.59% |
| 5.0- 9.9 | 9 | 2.90 | 1.58 | 1.32 |
| 10.0-19.9 | 6 | 2.49 | 1.64 | 1.86 |
| 20.0 and over | 4 | 1.84 | 1.07 | 0.77 |
| Total | 26 | | | |
| | | *Mining* | | |
| Under 1.0 | 0 | — | — | — |
| 1.0- 4.9 | 1 | 7.74% | 5.92% | 1.81% |
| 5.0- 9.9 | 0 | — | — | — |
| 10.0-19.9 | 0 | — | — | — |
| 20.0 and over | 0 | — | — | — |
| Total | 1 | | | |
| | | *Other* | | |
| Under 1.0 | 3 | 6.76% | 4.10% | 2.66% |
| 1.0- 4.9 | 5 | 5.43 | 3.39 | 2.04 |
| 5.0- 9.9 | 3 | 4.46 | 3.67 | 0.79 |
| 10.0-19.9 | 2 | 3.32 | 2.40 | 0.92 |
| 20.0 and over | 0 | — | — | — |
| Total | 13 | | | |
| | | *All Industries* | | |
| Under 1.0 | 6 | 7.46% | 4.76% | 2.70% |
| 1.0- 4.9 | 19 | 5.22 | 3.50 | 1.72 |
| 5.0- 9.9 | 15 | 3.29 | 2.19 | 1.10 |
| 10.0-19.9 | 11 | 2.78 | 1.95 | 0.83 |
| 20.0 and over | 6 | 1.70 | 1.22 | 0.48 |
| Total | 57 | | | |

[1] Expenses include the following items: SEC fees listing fees, Federal revenue stamps, state taxes and fees, transfer agent fees and expenses, printing and engraving, legal, accounting, engineering and miscellaneous.

Unfortunately, these figures are not very helpful, because they don't show the amount by which the subscription price was set below the market price. The only information given on this point for the 57 issues was as previously referred to: the median was 10%.

In a rights offering there are two principal types of underwriting compensation: a two-fee and single-fee deal.

In a two-fee deal, the underwriter is paid one base fee per share for all shares, and an additional fee per share on those shares which are purchased and sold by the underwriter. If the unsubscribed shares represent about 3%, a company would thus pay one fee on 97% of the offering, and a somewhat larger combined fee on 3%. If the issue turns out to be unsuccessful and a large amount is unsubscribed, then there is a corresponding increase in the cost.

The base fee is to compensate the underwriter for the risk he assumes, his expenses and the fee for the underwriting firm, which acts as manager. The additional fee on the unsubscribed portion is to take care of the job of selling that portion of the issue. It must be large enough to provide a sufficient incentive to selected dealers to sell the issue. A company should figure out what the over-all average fee would be for the two combined for various percentages of stock subscribed, in order to be able to compare it with a single-fee deal. In making a comparison, the company will have to weigh the extent to which shares may be unsubscribed. The advantage of a two-fee deal is that it adjusts *ex post facto* the commissions to be paid according to actual results.

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[9] *Cost of Flotation of Corporate Securities 1951-1955,* Securities and Exchange Commission, Washington (25) D.C., page 61.

In a single-fee deal, the underwriter is paid a fixed amount per share for all shares offered. It rolls into one fee the risk involved in the underwriting and the additional cost to sell the unsubscribed shares. One of the advantages of this form of agreement is that the company knows at the start the maximum that the underwriting will cost, no matter how much is subscribed. While some underwriting firms prefer the single-fee arrangement, some do not.

One additional feature, which may be contained in either type of agreement, is the split on the unsubscribed. The underwriter gets the shares which are unsubscribed and sells them at the best possible price. This produces an additional amount of money; who receives it will depend on the underwriting agreement. In the utility field, it may be split 50-50 with the company or on some other basis. The basis of the split may depend on the amount unsubscribed. For example, in an industrial offering, the company may receive the entire amount if the unsubscribed is 3% or less, the theory being that such a percentage represents the usual amount of rights which fail to be exercised. However, if the percentage of unsubscribed is greater, it may be due to adverse market developments which increase the underwriter's risk. Then the underwriter might receive some or all of the profit on the unsubscribed. The profit on the unsubscribed, when it is over 3%, may be split with the company on some formula basis, with the underwriter receiving a greater proportion as the amount of unsubscribed increases. It is proposed by some underwriters that the amount which the company receives as profit from the sale of any unsubscribed shares, at a price in excess of the subscription price, should represent a reduction in the over-all cost of the underwriting. On the basis of logic, it would seem to make more sense to consider that any amount going to the underwriter is part of his compensation; any amount which the company receives is additional proceeds. In the first place, everything belongs to the company, and anything the underwriters receive is derived from the company. Certainly, when studying underwriting costs, the relationship must be looked upon this way, in order that the costs for various forms of underwriting agreements will be on a comparable basis. Furthermore, consider the situation in which a company does not have its stock underwritten and sells the unsubscribed shares in the open market. The additional amount received would be added to the proceeds from the issue; there would be no other way to account for it.

Another part of compensation that goes to underwriters in a two-fee deal and which is not easily understood is the compensation for layoffs. This may turn out to be an important item. It will be discussed more fully when the term "layoffs" is described. It is a part of the total cost of underwriting. Briefly, a layoff consists of purchase of rights by an underwriter during the subscription period and sale of the stock obtained through those rights. In many two-fee deals, the underwriter receives the additional fee on all shares laid off. When estimating your cost in a two-fee deal, you will have to make allowance for the size of the layoff. In a single-fee deal, there is no fee for layoffs, although the underwriters can lay off stock if they wish to do so.

As an example of a two-fee deal, the wording might be as follows on the front of the prospectus: "The Company has agreed to pay the underwriters 75¢ a share in respect of all the shares offered hereby, plus an additional $1.00 a share in respect of each share of capital stock acquired by them through the exercise of rights purchased by them on each share of unsubscribed stock."

After the subscription period is over, the underwriters' compensation can be figured out from the sticker which is subsequently added to the prospectus. Here is an actual offering; explanations are included in the parentheses.

You may wish to note the underwriters' compensation and expenses for those issues included in the table in the previous discussion on pressure. They are listed for the underwritten issues at the base of this column.

| | *Number of Shares* | *Percentage of Total* |
|---|---|---|
| A. "Subscribed through rights" (by original stockholders or purchasers of rights other than underwriters and through purchase of rights by underwriters) | 6,595,528 | 99.2% |
| B. "Unsubscribed shares" (tag end) | 53,596 | 0.8 |
| "Shares offered by company" | 6,549,124 | 100.0% |
| C. "Underwriters subscribed for" (for purpose of layoffs) | 648,025 | |
| D. "Underwriters sold during the subscription period" (layoffs) | 635,766 | |
| E. "Shares offered by underwriters after the subscription period at $49.75" (unsubscribed shares plus shares subscribed for by underwriters not laid off) | 65,855 | |

The difference between the shares *C* (648,025), and shares *D* (635,766) is 12,259. These shares were added to *B* (53,596) to get *E* (65,855). On shares *B*, that is, the unsubscribed (53,596), the company received the difference between the $49.75 and the subscription price of $44.00, or a total of $305,808.06, after deducting transfer taxes.[10]

The compensation paid the underwriters was as follows:

| *Shares* | | *Fee Rate* | *Total* |
|---|---|---|---|
| 6,549,124 | (Base rate on all shares) | $0.75 | $4,911,843 |
| 648,025 | (For stock purchased for layoffs) | 1.00 | 648,025 |
| 53,596 | (Unsubscribed) | 1.00 | 53,596 |
| | | | 5,613,464 |

In determining a reasonable underwriting compensation for your offering, you will wish to look at the Securities and Exchange Commission figures previously referred to, in order to get some perspective on the effect of size of issue and type of industry. You should study all issues reasonably comparable with yours offered in recent years, having particularly in mind the percent discount by which the subscription price was set below the market. You

| *Type of Company* | *Underwriters' Compensation as a % of Market Price on Day Price Set* | *Expenses of Offering as a % of Market Price on Day Price Set* |
|---|---|---|
| *4 Industrials* | | |
| 1955-1957 Average | 1.7% | 0.4% |
| Range | | |
| Maximum: | 2.4 | 0.5 |
| Minimum: | 0.9 | 0.3 |
| *16 Electric Utilities* | | |
| 1953-1957 Average: | 0.9% | 1.1% |
| Range | | |
| Maximum: | 4.3 | 2.3 |
| Minimum: | 0.1 | 0.5 |

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[10] The underwriting agreement provided that all proceeds (after all expenses, including transfer taxes, but excluding concessions to dealers) on unsubscribed shares should go to the company, if the unsubscribed shares were 3% or less. If the unsubscribed were between 3% and 10% of the total offered, the company was to split with the underwriters, on a 50-50 basis, the profit on sale of the unsubscribed. If the unsubscribed were 10% or more, all profit would go to the underwriters.

will have to weigh all other factors of each issue which affected the risk.

## DIRECT OFFERING

In direct sale, the underwriters purchase the stock either on a negotiated basis or at competitive bidding, and then resell it to investors at the offering price. Competitive bidding for common stocks is used sometimes in the utility field.[11] Without exception, industrial stocks are handled on a negotiated basis.

We discussed the various risks of a market decline for a rights offering during the subscription period due to subscription period pressure, market break and possible adverse developments for the company. If underwriters bought a common stock issue at direct sale and held it for 20 days, the approximate length of time for a subscription period, they would be faced with the same type of risks. In their agreement with the company they would assume the first two risks, except for very adverse market conditions. However, in a direct offering, underwriters consider that it would be an unsuccessful deal if it took 20 days to sell. They hope to dispose of the stock in a few days at the most. Therefore, their risks are expected to be for a shorter period. Of course, the stock must be priced properly in order to assure a quick sale. Underwriters stress that through information meetings, etc., before the offering, they can further reduce the risk, by assuring a quick sale.

Let's go back now to the same place we started in a rights offering, just before the announcement of the offering, and follow a direct offering through from there. The market price for the stock will tend to decline from the day of the announcement to the day of the offering, due to pre-offering pressure. Just as in a rights offering, potential purchasers will tend to withhold their buy orders until the new stock is offered in the hopes of receiving a lower price, and there is the possible influence of dilution of earnings. The extent of the pressure will depend on all of the circumstances surrounding the offering.

When the day arrives for signing the agreement with underwriters, there are two questions to be resolved: the price which the underwriters will pay the company, and the offering price to the public; the difference between the two is the spread which the underwriters receive as their compensation.

Where will the offering price be set in relation to the market price of the existing stock? Will it be slightly above, the same or below? For example, if the market price is $100 per share, will the offering price be $100¼, $99, or $95? It depends on many factors, as follows:

1. How the market price has reacted after the announcement of the financing in relation to the general market; in other words, the extent of the pre-offering pressure. If it has been great, the market price may have overreacted. This will tend to justify a high offering price in relation to the market price. On the other hand, if the stock has held up better than would be expected, there may be reason for placing the offering price lower.
2. Most of the things covered under subscription period pressure for a rights offering and which will affect the attractiveness of the stock, such as:
   All the circumstances surrounding the new offering, including the size of offering and offering ratio;
   Everything which affects the quality and outlook for the company and its stock, and its relative attractiveness compared with other similar types of stocks;
   The nature of the existing market for the company's stock, including whether it is closely held, the type of holders, whether it is listed or not listed;

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[11] In 1959, of the 13 electric company common stocks of $2,000,000 and over sold directly, 54% were negotiated, and 46% competitive. In the previous year, the figures were 75% and 25% respectively.

The general condition of the securities market, including its relative level, and the general interest of investors toward the purchase of new issues.

3. The potential interest in the new offering, as indicated by the market canvass by the underwriters prior to the offering. The underwriters, through their contacts with purchasers, will feel out the attitude of buyers carefully before the price is set.

For example, if a company's stock has already decreased reasonably due to pre-offering pressure, then the offering price might be right at the market price, for a moderate-sized offering by a well known company with a favorable outlook and a broad market during a bull stock market. Without such unusually favorable circumstances, it would be expected that the offering price would be set at a slight discount up to one percent below the market. The discount will range higher as the factors become less favorable. It may have to be substantial for a small, little-known, speculative type of stock.

The price may be established on a so-called formula basis in relation to the market on the day the stock is offered. For example, the company and the underwriters will agree on the underwriting spread, either in terms of a percent or dollar amount, and that the offering price shall be within a certain range in relation to the market on the day the stock is offered. This stipulation has an advantage as a means of getting the registration effective before the final price is established. By handling this detail of registration, when the price is agreed upon and the underwriters purchase the issue, the underwriters can immediately start to sell. This may reduce the risk which they take, because they do not have to file the price and underwriting compensation with the Securities and Exchange Commission and wait the short time until it becomes effective. Generally, stabilization of the price will not occur until after the underwriting agreement is signed. However, it is natural in application of the formula method that there should be no stabilization before the offering; otherwise the market price would not represent a free market.

Once the offering price has been set and filed with the Securities and Exchange Commission, it cannot be increased by the underwriters if the issue turns out to be attractive and investors rush in to buy. That is, the price at which the underwriters offer the security must be adhered to. If the issue is a failure, when the agreement among underwriters terminates the members may then sell the remaining securities at whatever price they can obtain. However, it would be quite unethical, and illegal according to the Securities Act of 1933, for them to withhold securities of a successful deal in order to benefit by a price rise after the underwriting agreement was terminated. The same idea was referred to in the previous chapter, "Selling Senior Securities."

When a company has no stock publicly held and there is no market quotation available, there is no price which can be used as a guide to judge the offering price. Such a situation will occur if a company has been privately owned or is an entirely new venture. Then it will be necessary to make some estimate of how much the stock might be worth as compared with similar types of stocks for which there are available market quotations. This estimate will take the form of a statistical comparison with principal statistical ratios. The extent to which the stock will have to be discounted below a market estimate of its worth will depend on how well the company is known to investors and the interest that can be developed by potential investors. An offering of stock in a new, speculative venture might have to be offered at a substantial discount to make it attractive in relation to potential uncertain earnings. In such situations you will be more dependent on your underwriter's knowledge and best guesses.

It is generally considered beneficial to all concerned if a common stock is priced so that it can be sold within a reasonable length of time. If after the offering it immediately sinks in price, then the unsophisticated investors who bought it may feel some dissatisfaction and may not be as interested when the company offers more stock. These remarks assume a level securities market. The company cannot be expected to guard against a change in price due to a break in the general market.

Pricing a stock so that the deal will be successful does not mean setting such a low price that it is an obvious bargain. The company must definitely try in a direct offering to get as much net proceeds per share as possible, within the limits of the qualifications suggested above of making the deal a success. This they owe to existing stockholders. If, after the offering, the stock jumps to a substantial premium, without any change in the general level of the market, then it may indicate that the price was too low. By then it is too late, as far as the company is concerned. The cat is already out of the bag. The company must try to make certain that the offering price is satisfactory before the offering takes place.

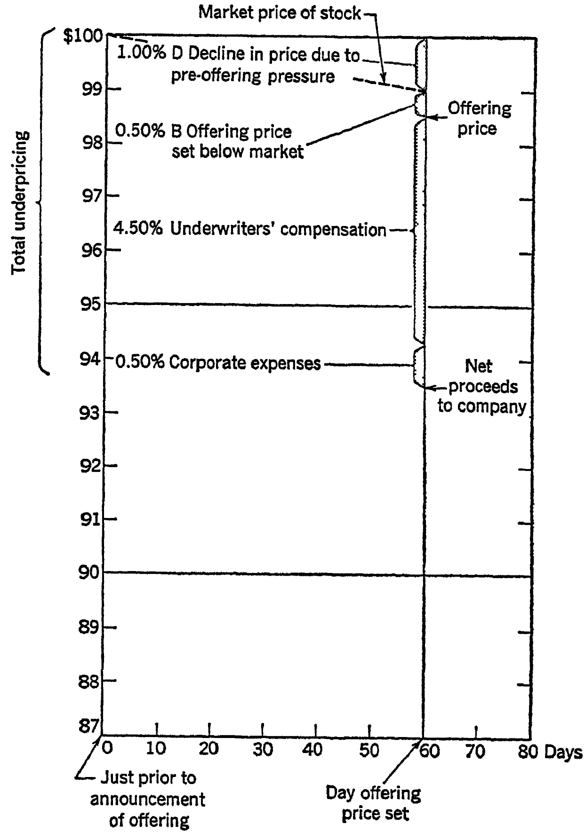
A direct offering is much simpler to understand than a rights offering, but, before we go on, it is summarized in a chart similar to the one for a rights offering, assuming that the general stock market holds level. The figures used for illustrative purposes on a per share basis are:

*Total Underpricing*

| | |
|---|---|
| Market price of stock just before announcement | $100.00 |
| Decline in price due to pre-offering pressure | 1.00 |
| Market price on day offering price set | 99.00 |
| Amount by which offering price is set under market | 0.50 |
| Offering price | 98.50 |
| Underwriters' compensation | 4.50 |
| Corporate expenses | 0.50 |
| Net proceeds to company | 93.50 |

A few words about the question of how much you should agree to pay the underwriters. They will perform two services:

1. Assistance and advice in preparing the financing for market;
2. Buying the security from you and taking the risk of disposing of it, except for the risks of possible adverse developments for the company and very adverse market conditions.



The risk the underwriters assume depends upon all the factors discussed above. If there is very strong demand, they may see where the stock can all be sold almost as soon as it is bought; then their risk is small. On the other hand, if the issue is a difficult one to sell, and they expect to hold at least a part of it pending a vigorous sales effort, their risk mounts up.

As was pointed out in Chapter VII, the gross compensation paid the underwriters has to cover four items: allowance to the selling group, management fee for the head underwriter, expenses and taxes, and allowance to cover the underwriting risk.

The allowance to the selling group, that is, to selected dealers, must be sufficient to induce dealers to take an active interest in pushing the issue. The size of the allowance will depend on the extent of the sales effort needed. It may be related to the commission for a trade on the New York Stock Exchange, but be larger in order to provide incentive to sell the new issue. It should be noted that only a small part of an issue may be sold by dealers; it is only on those shares that the allowance to dealers is paid. However, the underwriters will need some compensation for the sales effort of their own firm.

The amount required to cover the underwriting risk may be small for a high grade issue in a favorable market,[12] but it will increase for a more speculative type of stock in a poor market. The underwriters' compensation may be quite dependent on where the offering price is set, as that will have a lot to do with how quickly the issue can be sold. In your negotiation with underwriters, how can you know where the offering price should be set and the amount to pay them? You can't do too much. That is why you should be sure when choosing your underwriters that you evaluate their ability carefully. However, the difficulty of your being able to do a refined job does not in any sense suggest that you should not be sufficiently conversant with all available information so that you can negotiate with them intelligently. Some general figures on underwriters' compensation and also expenses, published by the Securities and Exchange Commission,[13] follow:

FINANCING COSTS

COMMON STOCK OFFERINGS DIRECT TO PUBLIC
1955

CLASSIFIED BY SIZE OF ISSUE AND INDUSTRY OF ISSUER
(Costs as Percentage of Proceeds)

| *Size of Issue ($ millions)* | *No. of Issues* | *Total Cost* | *Underwriters' Compensation* | *Other Expenses*[1] |
|---|---|---|---|---|
| | | *Manufacturing* | | |
| Under 1.0 | 11 | 14.87% | 11.71% | 3.16% |
| 1.0- 4.9 | 27 | 9.90 | 8.34 | 1.57 |
| 5.0- 9.9 | 4 | 7.14 | 6.41 | 0.74 |
| 10.0-19.9 | 1 | 4.53 | 3.99 | 0.54 |
| 20.0 and over | 0 | — | — | — |
| | | *Public Utilities (incl. Communication)* | | |
| Under 1.0 | 1 | 8.52% | 5.80% | 2.73% |
| 1.0- 4.9 | 6 | 5.87 | 4.89 | 0.98 |
| 5.0- 9.9 | 3 | 4.76 | 4.11 | 0.65 |
| 10.0-19.9 | 1 | 2.40 | 2.09 | 0.31 |
| 20.0 and over | 2 | 2.98 | 2.68 | 0.30 |
| | | *Mining* | | |
| Under 1.0 | 14 | 37.13% | 29.32% | 7.81% |
| 1.0- 4.9 | 15 | 19.72 | 17.23 | 2.49 |
| 5.0- 9.9 | 0 | — | — | — |
| 10.0-19.9 | 0 | — | — | — |
| 20.0 and over | 0 | — | — | — |
| | | *Other* | | |
| Under 1.0 | 4 | 25.21% | 18.93% | 6.28% |
| 1.0- 4.9 | 11 | 12.34 | 10.45 | 1.89 |
| 5.0- 9.9 | 1 | 14.28 | 11.76 | 2.51 |
| 10.0-19.9 | 3 | 6.60 | 6.15 | 0.45 |
| 20.0 and over | 0 | — | — | — |
| | | *All Industries* | | |
| Under 1.0 | 30 | 25.95% | 20.31% | 5.64% |
| 1.0- 4.9 | 59 | 12.16 | 10.39 | 1.77 |
| 5.0- 9.9 | 8 | 7.15 | 6.21 | 0.94 |
| 10.0-19.9 | 5 | 5.05 | 4.61 | 0.44 |
| 20.0 and over | 2 | 2.98 | 2.68 | 0.30 |

[1] Expenses include the following items: S.E.C. fees, listing fees, Federal revenue stamps, state taxes and fees, transfer agents' fees, printing and engraving, legal, accounting, engineering and miscellaneous expenses.

These figures are too general for a company to use as a direct guide, but they do bring out some points. Note the significant effect of size of issue. Costs for small issues are much larger. This is due to two factors: the smaller issues tend to be of less well-known companies, to which more risk is attached, and underwriters' expenses do not decrease proportionately with size. Also, note the difference among industries due to the risk factor. Remember that these figures leave out two elements of total underpricing, that is, pre-offering pressure, and the amount by which the offering price is set under the market.

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[12] For a high grade stock selling at approximately $25 per share, a breakdown of the underwriters compensation might be as follows: allowance to selling group, 60%; management fee for head underwriter, 15%; expenses and taxes, 10%; and allowance to cover risk, 15%. However, note that there would be a variation in the allowance to selected dealers as a percentage of gross compensation to underwriters, depending on the price of the stock, because brokerage commissions (which tie in with allowance to selected dealers) vary with the price of a stock. Furthermore, this allowance is paid only on that part of the issue which is handled by the dealers. These percentage figures assume that the entire issue was sold by dealers.

[13] *Cost of Flotation of Corporate Securities 1951-1955*, Securities and Exchange Commission, Washington (25) D. C., page 61.

In your negotiation with underwriters, you will need to understand thoroughly the principles discussed in this chapter. Secondly, you will undoubtedly wish to make an analysis of a number of previous offerings which were reasonably comparable. You should note the circumstances of those offerings which might make for a higher or lower offering price in relation to the market price and any difference in underwriters' compensation. Armed with this information, you should be able to understand the underwriters' proposals and negotiate intelligently.

The pattern for payment of underwriters for established companies is as described above. For small and untried companies, underwriters may take part of their compensation through allocation of some of the common stock at a discount below the public offering price. The amount of this discount must be considered as part of financing cost. It may turn out to be very sizeable. Generally, the underwriters hold their stock for more than six months in order to turn their profit into a long-term capital gain for tax purposes.

It is generally not easy to raise money for small, new ventures and the underwriters deserve adequate compensation. However, such a company should weigh carefully whether the cost to raise capital can be justified by the prospects for the company.

The picture, as far as the underwriters are concerned, changes considerably during a boiling stock market when speculative fever attracts people who will buy almost any type of new venture in a glamorous growth field. Then the sale of such issues becomes easier, perhaps too easy. This happened in the 1959 bull market. It was well described in a series of articles in the *New York Herald Tribune*. See how that paper expressed it:

> Securities and Exchange Commission investigators are on the prowl in Wall Street, trying to track down "insiders" who may be turning fast profits at public expense out of the rash of new stock issues that have thrown the over-the-counter market into a speculative uproar. . . . It doesn't take an awful lot of digging, though, to establish that the underwriters who specialize in the small promotional offerings causing all the tizzy are making money hand over fist. It's all quite legitimate; it all shows in the prospectuses tucked away in the S.E.C.'s files. . . . The big scores are not coming from commissions and expense allowances. They don't generate much more than walking around money. What the underwriters really shoot for is the fat capital gain. Some of these are very fat indeed.[14]

Four examples mentioned in the articles, with the name of the company and underwriter deleted, are as follows:

> Before offering (Company *A*'s stock) (the Underwriter) bought 45,000 shares for $45. The stock went to the public at $3.75 a share.
>
> (The Underwriter) bought 60,000 shares of (Company *B*) for $60. It went to the public at $3.75 per share.
>
> (The Underwriter) paid $50 for 50,000 shares of (Company *C*). The public paid $2 a share. . . .
>
> . . . In one small retail operation, where capital requirements tend to run relatively low, the insiders picked up 50% of the company for $16,000. The public got the other half for an investment of more than a million.[15]

Here is another offering described in the article which had a little different twist:

> (Company X's stock), like most such promotional issues, came to market on an "all or nothing" basis. If all the shares weren't sold, all bets were off and that's precisely what happened. Investors who had bought in got their money back and (Company X) was back where it started.
>
> Selling "all or nothing"—in effect, on consignment—entails no underwriting risk. The underwriter does not put up any cash, as he would if the stock were moving on a "firm commitment." On that basis he buys the stock from the issuing company, and then attempts to resell it. If he fails to place the issue, the loss is his. Few untried

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[14] Richard Phalen in the *New York Herald Tribune*, August 26, 27 and 28, 1959.

[15] *Ibid.*

companies can make that kind of demand. With stocks booming, it's an underwriter's market and they are making the most of it.[16]

These comments indicate that the cost of financing for small companies may be astronomical. When we get to Chapter X, "Profit Goals—Cost-of-Capital," it should be clear that a new venture would have to be "really" successful in order to achieve a profit goal sufficient to compensate for such financing costs.

## RIGHTS VS. DIRECT OFFERING

With this background, we can now help you in your decision regarding the big question posed at the beginning of the chapter: Should you offer stock through rights or by direct offering?

The reasons advanced by officials of some companies to justify their choice may be superficial. This is a typical comment in favor of a direct offering: "The poor stockholders take a beating because the rights get depressed during an offering. The professional traders take advantage of this, buy the rights and they are the ones who get the benefit, not the stockholders."

And here is another: "In a direct offering the company gets more money per share; there is less dilution of earnings because less shares need be sold, and therefore the company benefits." You will hear stockholder preference used to justify either method.

These points, of course, all have to be carefully weighed in deciding on whether you should sell new stock through rights or by direct sale, but such comments by themselves are not sufficiently comprehensive as a basis on which to make a decision.

### *Cost Comparison—Rights* vs. *Direct Offering*[17]

The first step is a proper cost comparison. The figures for direct offering are easy to set up, but not those for rights. With regard to rights, these points are often left out:

1. The stockholders receive some benefit from the rights. While the company may receive less cash per share through a rights offering, it is the stockholders who own the company, and the benefit the stockholders receive cannot be disregarded.
2. In calculating the benefit to stockholders, analysis must be made of three groups:
   Shares represented by original stockholders who subscribe.
   (1) They get full benefit of a rights offering.
   Shares represented by stockholders who sell their rights.
   (2) They benefit but less than the above group to the extent of decreased rights value due to the pressure when they sell.
   Shares represented by stockholders who fail to subscribe or sell.
   (3) They receive no benefit, but this group is generally small.
   To lump all stockholders together and assume that they are affected alike is quite erroneous.
3. In a direct offering the underwriters' compensation is a large cost, whereas it is relatively small in a rights offering if the subscription price is set at a reasonable amount below the subscription price. Some of the risk is absorbed through rights value, which goes to the stockholders rather than the underwriters.

The table on page 272 shows how a cost comparison for a direct offering *vs.* rights should be made. It is based on certain assumptions in order to simplify the picture and is primarily for illustrative purposes. These are the assumptions:

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[16] *Ibid.*

[17] This analysis should not be confused with a total underpricing figure for Cost-of-Capital purposes, which is covered in Chapter X. For that purpose, the "benefit to stockholders" in a rights offering is of no value unless it is fully compensated for in Cost-of-Capital. Furthermore, since a rights offering benefits stockholders and thus may provide a better market for the stock, Cost-of-Capital should cover a sufficient allowance for underpricing so that a company will be able to offer stock through rights.

1. The stock is a relatively stable type like that of an electric utility company.
2. The figures for underwriters' compensation, corporate expenses, etc., are as previously shown in the two charts used to illustrate a rights and a direct offering.
3. The shares in the rights offering represented by subscriptions by original stockholders, subscriptions by purchasers of rights and lapsed rights are 50%, 47% and 3%, respectively, which is a reasonable assumption for this type of common stock.

The results of the comparison will, of course, depend to a large extent on these figures. And they will differ with each offering, but they are at least enough within the realm of reasonableness to be meaningful. The table provides a form for a company to use in making such a study, with figures which will fit the circumstances surrounding its stock.

If you have trouble in understanding the table, go back to the summary charts on rights and direct offering (pages 254 and 267).

The direct offering is rather simple. The total in Column I is:

*Direct Offering* $4.50\% + D + B$

For the rights offering, it is necessary to break down the stock into the three different actions by the stockholders in order to get the benefit,[18] and then subtract the total benefit in Column VI from the total cost to the company in Column II. Note the two items which apply equally to all shares, the underwriters' compensation and corporate expenses. The former for a rights offering is much less than for a direct offering. The expenses of a rights offering are generally greater than for a direct offering because of the additional work in handling the subscriptions. Column II less Column VI gives us the combined effect and is what we need for our comparison with a direct offering.

*Rights Offering—Combined Effect*

$$2.21\% + 50\% \times P + 47\% \times S$$

In order to simplify the comparison, we will now fill in the other figures we used in the charts, except for S, the subscription period pressure. They were 1% each for P and D, and ½% for B. Then the results would be as follows:

*Direct Offering*

$$4.50\% + D + B$$
$$4.50\% + 1\% + \tfrac{1}{2}\%$$
$$6.50\%$$

*Rights Offering—Combined Effect*

$$2.21\% + 50\% \times P + 47\% \times S$$
$$2.21\% + 50\% \times 1 + 47\% \times S$$
$$2.71\% + 47\% \times S$$

By solving algebraically for S,[19] it can be

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[18] In order to keep the table from becoming too involved, we left out the following point in column IV: When stockholders sell rights, their benefit is reduced by the brokerage charges and transfer taxes in connection with the sale. By way of explanation, if a right had a market value of 30¢, and a stockholder owning 100 shares sold 100 rights he would receive $30, less brokerage commissions of $1.80, and taxes of $0.04 (assuming no par stock listed on the New York Stock Exchange, with $30 per share market value) making a total of $1.84, which is 6.1% of the rights value. If we apply this to the full 7.00% for the amount the subscription price is set below market on the day the price is set, it would mean a reduction of 0.427% from our Benefit to Stockholders, but it only applies to 47% of the stock so that the net effect is only 0.20%, a negligible over-all amount.

Again, in order to keep the table from becoming too involved, we left out the following point in column V: The rights that are lost, *i.e.*, neither subscribed nor sold, are a total loss to the individual stockholders but not necessarily a total loss to the company. If the offering is not underwritten, the company can sell these shares at the market price and thus get the full amount. If the offering is underwritten, the underwriting agreement may provide for division between the company and the underwriters of the difference between the subscription price and the market price at which these shares are sold. Thus, the company gains some of the benefit lost by the stockholders. This amount is generally small because the number of rights involved is small.

[19] Direct Offering Subscription Offering

$$6.50\% = 2.71\% + 47\% \times S$$
$$\text{(Transposing) } 47\% \times S = 6.50\% - 2.71\%$$
$$47\% \times S = 3.79\%$$
$$S = \frac{3.79\%}{47\%}$$
$$S = 8.1\%$$

seen that in order for the combined effect of a rights offering to be as great as the direct offering, S—the average subscription period pressure—could be as much as 8.1%. The maximum pressure during the subscription period would seldom approach this figure, and the average figure generally would be substantially lower. Thus, on the basis of these figures, it would appear that rights offerings are more beneficial to the stockholders when viewed from an analysis of all items.

| | DIRECT OFFERING | RIGHTS OFFERING | | | | | |
|---|---|---|---|---|---|---|---|
| | Cost to company | Cost to company | Benefit to stockholders | | | | Combined effect. Cost to company less benefit to stockholders |
| | | | Who subscribe | Who sell rights | Who fail to subscribe or sell | Total benefits | |
| Column | I | II | III | IV | V | VI | VII |
| Pre-offering pressure | D | P | P | | | | |
| Subscription period pressure | (Does not apply) | | | (1)<br>-S | | | |
| Offering price set below market on day price set | B | 7.00% | 7.00% | 7.00% | 0.00% | | |
| Underwriters' compensation | 4.00% | 1.00% | | | | | |
| Corporate expenses | 0.50 | 1.00 | | | | | |
| Total | 4.50%<br>+B<br>+D | 9.00%<br>+P | 7.00%<br>+P | 7.00%<br>-S | 0.00% | | |
| Shares affected | 100% | 100% | 50% | 47% | 3% | | |
| Total | 4.50%<br>+D<br>+B | 9.00%<br>+P | 3.50%<br>+50% x P | 3.29%<br>-47% x S | 0.00% | 6.79%<br>+50%P<br>-47%S | 2.21%<br>+50% xP<br>47% xS |

In the above figures, it was assumed that the pre-offering pressure for a direct offering, D, and a rights offering, P, were both 1%. Since all the stock in a direct offering comes on the market whereas that amount subscribed by original holders in a rights offering never comes on the market, it might be expected that D would be greater than P because of the greater supply. Because of the problems involved in measuring pre-offering pressure, this refinement may be worth keeping in mind without specifically allowing for it in the figures.

### *Complete Comparison—Rights* vs. *Direct Offering*

With the above discussion as a background, let's go over the points you will have to weigh in making a decision as to which method you should use.

1. *Legal aspect.* Some state laws require companies incorporated therein to offer common stocks and securities convertible into common stock by means of pre-emptive rights to existing stockholders. The charters of some companies have provisions requiring the use of pre-emptive rights. Some regulatory authorities have shown a preference for companies under their jurisdiction to use the rights method.

The primary basis for this obligatory requirement was the original reason for rights—to prevent the management of a company from selling additional stock without each stockholder having an opportunity to maintain his existing position. This was for the purpose of preventing two types of abuses by the management: sale of stock to a select group at a cheap price so that the select group would receive a monetary benefit, or sale of stock to a select group at a reasonable price but with the select group acquiring control so that it could subsequently benefit.

For large companies with a broad group of stockholders, this original reason for rights is not very important today. It is unlikely that insiders would try any such shenanigans to benefit a select group. Financing by this type of company is so much in the public eye that the management could not easily conceal such wrongdoing, even if they wished to do so. Furthermore, the matter of control is relatively unimportant because the ownership of a large, publicly-owned company is in most instances so widely spread that no one stockholder has any effective control.

For smaller corporations, which are less in the public eye and where stockholders do have a substantial interest which they wish to maintain, a requirement for pre-emptive rights may provide some protection to existing stockholders. Generally today, the principal factors in deciding on direct offering *vs.* rights do not center around the question of protection against management's abuses.

2. *Net proceeds per share received by company.* The net proceeds per share received by the company in a direct offering will generally be somewhat more than in a rights offering, because of the need to make the rights have some value. Those in favor of a direct offering make much of this point. They may overemphasize it.

In our comparison of direct offering with rights, assuming P and D are equal and that B is ½%, the company would receive 3.50% more in the direct offering than in a rights offering. This sounds large and as if it would result in considerable dilution in earnings per share, because in order to get the same amount of money additional shares would have to be sold in a rights offering. Let's see what would actually happen even if the amount were as large as 5%. This case can be illustrated by a few figures, as follows:

| | |
|---|---|
| Earnings available for common before financing | $5,000,000 |
| Outstanding shares | 1,000,000 |
| Offering ratio | 1 for 10 |
| Shares offered | 100,000 |
| Market price per share prior to announcement of financing | $50.00 |
| Earnings per share prior to financing | $ 5.00 |
| Net proceeds per share Direct Offering | $47.00 |
| Total proceeds Direct Offering | $4,700,000 |
| Net proceeds per share Rights Offering[1] | $44.50 |
| Shares sold by Rights Offering to get same proceeds as Direct Offering | 105,618 |
| *Assuming no additional return on capital* | |
| Earnings per share, after offering with Direct Offering (1,100,000 shares) | $4.545 |
| Earnings per share, after offering with Rights Offering (1,105,618 shares) | $4.522 |
| *Assuming 10% earnings on new capital* | |
| Earnings per share, after offering with Direct Offering (1,100,000 shares) | $4.973 |
| Earnings per share, after offering with Rights Offering (1,105,618 shares) | $4.948 |

[1] 5% less than direct offering: 5% × $50 = $2.50. Subtract this from $47.00 per share to get $44.50.

The diluting effect per share is about 0.5%, whereas there was about 5% less net proceeds per share with a rights offering. Why so little diluting effect? The answer is easy. Earnings per share are figured on the basis of total number of shares and the diluting effect is thus decreased. It is only the new shares which are affected by the full dilution, and they are 10% of the outstanding shares. In other words, if a company offers stock on a 1-for-10 ratio, which is 10% more stock, and there is 5% less net proceeds per share for the new shares with a rights offering, then this will produce only 0.5% dilution in per share earnings on total shares outstanding after the financing. It would take ten such offerings of stock, or a 100% increase in the total shares, before the diluting effect on earnings per share would be as much as 5%.

The effect of dilution on earnings of rights offerings should not be overemphasized, particularly since the stockholders get some benefit from rights. Only if a company is determined to get the greatest net proceeds per share, without regard to the benefit of rights to stockholders, will it probably prefer the direct sale method, because as pointed out above in a rights offering, it is generally not wise to set the subscription price so high that the rights have little value.

Another situation making for a small rights value arises when a relatively small amount of stock is offered. Then the offering ratio is high, and automatically the value of the rights becomes small unless the subscription price is set very low. Such a situation might tend to favor a direct offering.

3. *Benefit to stockholders.* In a rights offering the stockholders get the benefit of the option to purchase at a reduced price, as discussed above. This advantage should be properly analyzed as in the table. If the benefit to the stockholders is deducted from the cost to the company to get the combined effect, the picture becomes quite different than it appears when the emphasis is placed on point 2 above about net proceeds per share alone.

4. *Stockholders preference.* Some stockholders are outspoken in favor of rights. They like the added benefit. It has the advantage of being taxed as a capital gains. Other stockholders just don't like them. For example, institutions, which handle the investments of a large number of individuals, must do a lot of paper work and correspondence with their clients when there are rights offerings.

The following passage from a survey of 891 large and small individual stockholders in large and medium sized companies is perhaps of some interest:

> Rights to subscribe to new stock at prices below the market were overwhelmingly approved by all classes of individual stockholders. Small stockholders, whose tendency to allow rights to expire unused has worried many managers, are more emphatic in their approval than other classes. And comparison with the 1951 survey indicates that rights are even more popular than seven years ago.[20]

Some companies have been able to obtain a favorable vote from stockholders to change their charter, giving the management the choice as to whether stock should be offered through rights or direct. This should not necessarily be interpreted as a vote against rights. A stockholder might feel that it was wise to give the management flexibility in this regard and yet still prefer rights if there were no compelling reason for the management to do otherwise. If such a change is made in a charter, it may be provided that stock offered without rights must be offered publicly in order to prevent an inside deal.

A company might do well to make a survey based on a scientific sample of its stockholders in order to determine their wishes on the subject. The results should be calculated on the basis of number of shares and not of the number of stockholders.

5. *Effect on market price.* Since there is a benefit to stockholders in a rights offering, it would be reasonable to expect that the market price of a company's stock would reflect this benefit to some extent. While the benefit might be difficult to measure in most cases, because so many other factors affect the price of a stock, nevertheless it cannot be overlooked. This would apply particularly if a company followed a consistent policy of offering stock regularly through rights.

[20] Survey made under the auspices of the Bureau of Business and Economic Research of the University of California. As reported in the article, "What Do Stockholders Like" by John Clendenin; Volume I, Number 1 Fall 1958, *California Management Review.*

6. *Assist in raising capital.* Sometimes, it may be necessary to use a rights offering in order to raise the amount of money required in a common stock offering. For example, when an issue is very large, a rights offering might be helpful by inducing stockholders to dig down into their pockets and put up the money, whereas they might not bother if there was a direct offering. Thus, an added source of new capital is tapped which might not be reached through a direct offering.

At certain times, margin requirements for shares purchased through rights is substantially less than for direct purchases. This may provide an added market appeal for rights and assist in raising capital. For example, borrowings by stockholders in order to subscribe might add to the amount of money available to take up the issue. For large issues this may be a significant factor.

On the other hand, if a company has offered stock on a rights basis often,[21] it might find that a decreasing number of stockholders would subscribe, because they did not have the funds or already had enough of the stock. In such a situation, a direct offering might be advisable in order to bring in a new group of stockholders. A company should be sure of its ground before using this as a reason. Keeping a record of the number of original stockholders who subscribe will assist in making this decision.

If a large amount of a company's stock is held by a small number of investors, who are known not to want additional stock, then a direct offering might fit the picture better. If a rights offering were used, an arrangement would have to be made for underwriters to handle the rights which would be received by this group of stockholders.

7. *Cultivation of dealers in a rights offering.* As previously stated, if a stock is listed, dealers tend to lose interest. Payment of dealer compensation in a rights offering represents a way to keep dealers interested in a listed stock. This will be discussed shortly.

### *Summary—Rights* vs. *Direct Offering*

Where does this all lead us?

The original purpose for rights—to prevent management abuses, by sale of stock to insiders—may still be worthwhile in smaller companies not in the public limelight. However, the large companies couldn't hide such a maneuver even if the desire to do so were present. Therefore, in deciding on which method is preferable, we must look to what is best for the company. That includes the stockholders, since they own the company.

Direct sale may produce the greatest net proceeds per share, but the argument that it thus prevents the serious dilution caused by a rights offering is not sound. The added dilution of rights offering is not serious. Furthermore, mere emphasis on the greatest amount of net proceeds per share clearly disregards allowance for the benefit to stockholders of a rights offering. If rights are appreciated by stockholders, they may have a favorable effect on the price of the company's stock. Make proper allowance for this benefit and have your stockholders in mind as the real owners of your company. You should heed your stockholders' wishes, but be sure you have a comprehensive sample based on the number of shares.

There are, of course, situations in which direct sale may be preferable, but it would appear that you would do well to have good reasons for not using rights before you decide otherwise.

So, if you are forced to use the rights method of offering stock by state law where your company is incorporated, don't feel too badly. If there is no such requirement, a company's charter which permits the use of either method may be preferable, because it provides greater flexibility. However, given the choice, it would appear that when weighed from the point of view of the combined benefit to the company and stockholders, the balance generally favors the rights method.

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[21] Southwestern Public Service Company found that original stockholders continued to account for 60% of the shares subscribed even after 7 offerings in 10 years. They concluded that their stockholders were a good continuing source of capital.

## SUBJECTS RELATED TO COMMON STOCK FINANCING

There are many other subjects which should be covered in connection with offering common stock. Some will now be touched on in order to give you a general idea of what they are about. Most of them have to do with rights offerings; some apply to direct offerings. In each heading which follows, it will be indicated whether the subject is applicable to a rights or direct offering, or both. If you have made your decision as to which method to use, you need only read the material which is applicable.

### *Stabilization—Rights and Direct Offering*

Stabilization may be used in practically any type of financing. Its purpose is to maintain the price of a security at a certain level. In order for this to occur, a bid is placed in the market to purchase any of the security coming on the market at a specific price. As long as the bid price is continued, the market price cannot fall below that level. However, price maintenance can be done only in a limited way. The price of a stock is determined by the supply and demand. If the supply becomes great, it will be necessary to purchase that supply in order to maintain the price. And if securities are being offered, the net effect is to reduce the amount offered by the amount purchased for stabilization purposes. Therefore, stabilization can be used only to prevent a small supply of stock from causing a price decline due to a temporary imbalance in the market. To this extent, stabilization may be helpful.

How stabilization is carried out will depend on the nature of the offering. Generally, it is used in common stock financing. A simple example of how it works is as follows: An underwriting firm in a negotiated financing of a direct offering of common stock signs the underwriting agreement with the company and agrees to pay to the company $95 per share. The underwriters plan to offer the stock at a price of $100, so that their spread is $5. At the time of the signing of the underwriting agreement, the market price of the stock is $101. Once the underwriting agreement is signed, the underwriters may put in a stabilizing bid at a price of $100. Thus, the public offering price agreed upon with the company is protected against a decline as long as only a small amount of stock is thrown on the market by the public. If the general market for stocks sinks and the underwriters are hit with a large amount of stock, they may have to "pull" their stabilization bid; otherwise they would be defeating their own purpose. They would be buying stock on balance rather than selling the stock they had underwritten. When the market sinks, they have a turkey on their hands as far as the underwriting is concerned. But they would only be aggravating the situation by trying to stem the tide through stabilization.

Stabilization requires an intimate knowledge of security markets and must be handled by experts. If a company offers stock through rights and the issue is not underwritten, it may wish to have the right to stabilize. This must be spelled out in the prospectus. However, the company should employ an underwriting firm familiar with security markets to handle the operation. In order to prevent manipulation of security prices, the Securities and Exchange Commission carefully limits the procedure followed in stabilization. A stabilization bid must be reported to the Securities and Exchange Commission. If a stock is listed, the bid goes on the quotation tape and is so designated.

Why should the Financial Vice President know about stabilization? For two reasons: so that he will realize that it may play a part in assisting the market action of his company's stock during an offering, and secondly, that if it is applied, except to assist the market in a limited way, a serious financial fiasco may result in a sinking market.

At this point, we might also mention the term overallotment. Some purchasers of a new issue may change their minds about holding it while the offering is still in the process. To take care of this possibility, the underwriters may overallot the amount offered to dealers, so that they can absorb the part that may pop back. The right to overallot will be included in the underwriting agreement and may be limited to 10% of the issue.

### *Layoffs—Rights Offering*

Starting around 1947, there was an innovation in the operation of a rights offering, fostered to a large extent by the late Eugene Barry of the underwriting firm of Shields and Company. It is known as the layoff, Barry or Shields plan. The term itself, *layoff*, refers to the act of selling stock. The original purpose of the plan was to permit underwriters to reduce their risk and lower underwriting costs, by providing for an orderly distribution of stock purchased by the underwriters on the exercise of rights bought in the market. When this provision is included in the underwriting agreement, it sometimes permits offering shares to stockholders at a higher subscription price and for a lower underwriting compensation than could be obtained from underwriters without such a provision.

The rights held by stockholders who exercise them never come on the market; the underwriter's risk is reduced to that extent. If, before the stockholders get around to subscribing, the market price falls below the subscription price, then they would not subscribe. There is nothing that the underwriters can do about it. The unsubscribed shares would belong to the underwriters at the end of the subscription period.

The rights that are sold come on the market. While the rights have value someone will buy them, and as long as they continue to have value throughout the subscription period, the purchasers will subscribe. If, subsequent to their purchase, the market price of the stock falls below the subscription price, then subscriptions will not take place. Thus, the underwriters would have to take up this stock. Under the layoff plan, the underwriters can protect themselves against this occurrence. In essence, it works this way: underwriters purchase rights during the offering period, they exercise the rights, and sell the stock to the public. They cannot get stuck with this stock at the end of the subscription period if, following the layoff, the market price falls below the subscription price.

The underwriters automatically get the small amount of unsubscribed or "tag end" shares which result from lapsed rights even though the offering is a success. To eliminate the risk with regard to these shares, the underwriters may go short, during the rights period, the estimated amount of tag end.

When the layoff plan was devised, it had to be cleared with the Securities and Exchange Commission, in order not to violate the regulations regarding market price manipulation of a stock. The Investment Bankers Association issued a memorandum setting forth the principles that would govern the conduct of underwriters during the rights period. Layoffs have to be carried out in a carefully prescribed manner. It requires a detailed knowledge of trading regulations. You do not need to know them but merely that they exist.

The extent of decrease in risk of the underwriters depends upon the amount of stock laid off. It is only that particular stock which the underwriters have assurance will not have to be taken up at the end of the subscription period if the market price should fall below the subscription price.

There is another reason advanced for layoffs; they help provide an orderly market for the rights during the subscription period. When there is a flood of rights, the underwriters buy them, thus supporting their price, and sell the stock. If underwriters feel that this is necessary in a single-fee deal, they may require compensation large enough to cover it. The underwriters will explain that a generous selling commission will lead to orders in excess of the shares to be supplied. But remember that when they sell the stock some pressure may be put on the market, which may cause a decrease in price and be reflected back to the rights through parity. You can't go too far in this operation without defeating your purpose. Furthermore, you must be familiar with arbitrage to complete your understanding of market operations during a rights offering. When there is a sag in the rights price, the arbitrageurs will be providing support to the market in a manner similar to the layoff operation. Arbitrage was explained in Chapter VI.

Why should the Financial Vice President worry about layoffs? For these reasons: he ought to know what is back of the market action of the stock and rights, and, most important, the company may pay for layoffs. The underwriting agreement may include a fee to be paid for stock taken up by the underwriters through purchase and exercise of rights, that is, through layoffs. In the two-fee deal, the underwriters usually get the same fee on layoffs as the additional fee for unsubscribed stock. Therefore, layoffs may substantially increase the cost of the underwriting to the company. This was referred to in the section on the use of an underwriter.

Of course, if the risk to the underwriters is reduced by layoffs, then there is an advantage to the company, as a smaller risk may reduce the over-all underwriting cost. However, a company should make certain that this is the reason for layoffs. If the subscription price is set well below the market price so that there is relatively little risk of the rights becoming worthless, then there would be no occasion for a large amount of layoffs in order for the underwriters to protect themselves, and a small amount only reduces the underwriters' risk to that extent. As a matter of interest, it may be noted that the largest offering ever of common stock, of over half a billion dollars by American Telephone and Telegraph Company in 1956, was done through rights with no underwriting and that the market action during the subscription period was remarkably good.[22] Of course, it is a relatively stable type of stock, and the discount was substantial. The right of layoff becomes more important to underwriters when the subscription price is set close to the market. Then they might need to make substantial layoffs in order to reduce their risk.

In certain situations, a form of layoff may be used to assist in the distribution of stock of certain larger holders who are known in advance of the offering not to be interested in exercising their rights because of the large additional investment, or in order to avoid further concentration of investment. This type of layoff will be planned in advance to take care of those specific rights.

You will wish to understand why layoffs are used in your offering, and make certain that they perform a necessary function.

### *Oversubscription—Rights Offering*

The tag end shares in a rights offering can be eliminated by means of an oversubscription privilege included with the regular subscription. When the holders of the rights subscribe, they can be given the right to request allotment of the tag end shares at the subscription price. After the subscription period is over, the shares which become available are allotted, generally in full shares, pro rata among those who put in an oversubscription on the basis of their original number of rights.

In favor of the oversubscription are these arguments:

> The unsubscribed shares are eliminated. This may become more important if an offering is not underwritten, because it will assure that all the shares will be sold, and that the company will not have the unsubscribed shares to sell after the subscription is over.
>
> The stockholders are given the opportunity of obtaining some additional stock at the subscription price.
>
> It gives some added value to the rights, and to this extent tends to help the price of the rights. The arbitrageurs like it, because it affords them a small extra play in the rights.

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[22] This Company made an even larger offering of common of around one billion dollars on a similar basis in 1961.

If the issue is touch and go, it may give it a little boost.

An example of how oversubscription might affect the rights value is as follows:

| | |
|---|---|
| Assume: | |
| Shares outstanding | 1,000,000 |
| Shares offered | 100,000 |
| Offering ratio | 1 for 10 |
| 95% of shares subscribed, leaving 5% for tag end. | 5,000 |
| Stockholders, owning ½ of the stock, apply for oversubscription. | |

There will be available 5,000 shares to allot pro rata to original holders of 500,000 rights.

| | |
|---|---|
| Assume: | |
| Market price of stock per share, ex-rights | $32.00 |
| Subscription price | $30.00 |
| Rights value without allowing for value of oversubscription | $0.20 |

A holder of 100 rights who oversubscribed would get 10 new shares through direct subscription and 1 share through oversubscription. He would thus have 11 shares worth $352 at the market price, for which he would pay $330, the subscription price. This would make his 100 original rights worth $22.00, or $0.22 per right. The oversubscription privilege added $0.02 per right for those who availed themselves of the privilege.

Against oversubscription are these arguments or complaints:

If the issue is underwritten, most underwriters don't like it. They lose any possibility of any split on unsubscribed shares. Furthermore, they feel strongly that it makes the issue more unmanageable as regards layoffs.

Those who oppose oversubscription contend that the average stockholder doesn't really understand it and therefore doesn't take advantage of it. The professionals, such as the arbitrageurs, are the ones who benefit. Of course, if they like it, that tends to create additional interest in the rights.

The company gives up the opportunity of any profit on the unsubscribed shares.

One thing is certain, oversubscription will not save an unsuccessful offering. If the market price falls below the subscription price, oversubscription will not make it anymore worthwhile to subscribe.

If you decide to place the subscription price close to the market so that the underwriters will have a substantial risk, you may find it better to bow to their objections to oversubscription. With a greater spread between the market price and the subscription price, you may wish to weigh more carefully its use, particularly if the issue is not underwritten, because then the tag end would be taken care of. These are the questions you should be thinking about in making your decision about oversubscription: Do you want to eliminate the unsubscribed shares and give a little kicker to your rights value with oversubscription? Or would it be better to do without it, get some profit on the unsubscribed shares and eliminate the underwriters' dissatisfaction? Actually, oversubscription is not a major financial issue, but more of a fine point. It will show your financial finesse if you know how it works and all the pros and cons as to whether it should be used in your offering.

### *Dealer Compensation—Rights Offering*

In a rights offering, the greater the amount of stock subscribed by the original stockholders, the better, provided it is in their interest to do so. This prevents the rights from coming on the market and reduces the pressure.

The small, unsophisticated stockholder may not know what to do or how to handle a subscription. He may turn for advice to his security dealer. Giving such advice takes up the time of the dealer, and if he should recommend that the stockholder subscribe, the dealer will undoubtedly have the warrant processed through his firm with the ensuing paper work and expense, similar to that if a security were purchased. The dealer receives no compensation for this work, since there is no established way to charge the stockholder. Many security dealers are very vocal on this point. They feel that it is an imposition, caused by the company which issues the stock. In view of this fact, human nature being as it is, there may be a tendency for a dealer to recommend to a stockholder that, instead of subscribing, the rights be sold and another security purchased. In this way, the dealer would make money on both the sale of the rights and purchase of the other stock. But this will mean more rights coming on the market and more pressure.

Many security dealers have contended that the company offering the security should pay a fee to dealers for the work involved in helping stockholders subscribe. Some companies do. This is what is known as dealer compensation. A dealer who helps a stockholder subscribe has his name stamped on the warrant, and the company pays a fee on the basis of the number of shares subscribed. Payment of the fee tends to increase the amount of subscriptions and thus reduces the pressure.

If dealers purchase rights themselves in order to subscribe, dealer compensation may be paid on those rights. An additional incentive is thereby provided for dealers to trade in rights—which tends to improve the market. However, the Securities and Exchange Commission frowns on this practice and special approval must be obtained. If a firm accepts dealer compensation, it cannot actively trade in the offering. Some large firms would rather trade and are not interested in the compensation.

The fee is around 1% of the price of the stock. For a stock selling at $30 per share, the fee would be 30¢ per share for each share for which a dealer assists in the subscription. A limitation is imposed on the maximum payment on any one transaction—which may range from $150 to $250. If about one-third of the entire issue passes through dealers' hands, the over-all cost will be less than ½ of 1% of the total issue. The fee per share should bear some relation to the New York Stock Exchange brokerage commission, because it represents the type of work a dealer would have to do in selling a stock to a customer. The fee can be somewhat less. Since the cost is so small, not much of a decrease in pressure is necessary in order to pay for the cost.[23]

If an issue is not underwritten, the company may handle payment of dealer compensation itself. However, some companies have employed an underwriting firm to act as dealer-manager and supervise the operation. If an issue is underwritten, then the company can arrange with its underwriter also to act as dealer-manager.

Some companies which have used dealer compensation swear by it. They point out that it not only compensates dealers who are approached by stockholders, but acts as an incentive to dealers to look up little stockholders and get them to act. Thus, subscriptions by original stockholders are increased, and the supply of rights coming on the market, which tends to lower their price, is reduced. If dealers know that a company will pay dealer compensation when there is a rights offering, they may be more interested in recommending the stock to their customers at other times.

Some company officials are strongly opposed to dealer compensation. They state that it is completely unethical for a dealer to be swayed in his recommendation of investment policy merely because he gets a fee for assisting with subscriptions. He should give his best advice to his customer regardless. It is a service which dealers should provide their customers. If anyone should pay the dealer, it should be the stockholder who uses the dealer's services. Furthermore, a company should set up adequate machinery to assist stockholders to subscribe, and if that is done, dealer compensation is a duplication of costs.

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[23] In a comparison of 12 offerings having dealer compensation with 12 approximately similar offerings without dealer compensation, the average pressure for the former was slightly lower than the size of the dealer compensation as a percentage of the market price per share. For those issues with compensation, the fee was paid on only about ⅓ of the number of shares, so that the cost related to the entire issue was relatively small. Since pressure is difficult to measure, reliance should not be placed on these figures as to the exact effect of dealer compensation, but they do show that it tends to be beneficial and pays for itself. See "A Technique of Offering Common Stock Through Rights" by John F. Childs, *Public Utilities Fortnightly Magazine*, November 11, 1954.

Underwriting houses generally oppose dealer compensation. They would rather have a straight underwriting. Some have expressed a fear that if dealer compensation came into general use, companies would pay a smaller underwriting fee, or not use an underwriter at all. This argument does not seem well founded. Whether or not an underwriter is used will depend on whether the subscription price is set sufficiently below the market prices to eliminate the risk of failure of an offering. Dealer compensation will have some beneficial effect on an issue but not enough in itself to eliminate the use of an underwriter. It may improve the rights value somewhat and benefit the stockholders, or a company may wish to take advantage of the slightly better rights value and set the subscription price slightly higher in order to recoup the cost of dealer compensation. While dealer compensation may reduce the risk of a decline in rights value and to that extent shade the amount paid to underwriters, they should not fear that it will have any major adverse effect on their business. In any event, be prepared to have most underwriters say that it is a waste of money.

Even though some dealers feel that it is unfair not to pay dealer compensation, many such firms are also engaged in the underwriting business. Consequently, the ones who are strictly dealers have not been able to get all dealers to join together in a united front in its favor. Furthermore, some dealers have gotten so wrought up on the subject that they haven't helped sell the idea. Some have even hurt their own cause. Apparently a few have threatened to boycott offerings and recommend sale of all rights, unless dealer compensation were paid. It has been said that dealers have approached large institutions, requesting that the institutions process their rights through the dealers so that they can collect the dealer compensation. This, of course, is unsound, because institutions do not need assistance and can send their rights in directly. In certain instances, it has been reported that some dealers have requested institutions to break up a subscription into smaller pieces so that they could get the maximum allowed compensation on each part. That is wrong. The fee should only be sought by dealers who help stockholders needing assistance. It is on the basis of this benefit alone that they should seek its acceptance. In order to avoid unnecessary payments, a company may wish to include, in the material sent out with warrants, a clear and simple notice in large red type warning stockholders not to have dealers' names stamped on warrants unless their assistance is actually needed; it is the company's and therefore the stockholders' money which is being spent, and it should not be wasted.

The technique of handling dealer compensation is not altogether simple. If it is handled incorrectly, some money will be wasted. A company which decides to use dealer compensation should not try to do a rush job. It should contact other companies which have used dealer compensation, and take advantage of the techniques they learned through actual operation. That will pay off, and in fact is quite necessary. Rush jobs will be bound to produce poor results.

Dealer compensation has not been widely used, but some companies have found it worthwhile and stick to it each time they offer common stock. You may wish to investigate whether it is worthwhile for your company, particularly if you do not have your issue underwritten.

### *Delayed Payment—Rights Offering*

To enumerate all the special features to assist in an offering of common stock would take a large book. As one illustration, there was the delayed payment used in the largest offering ever of common stock, referred to previously (page 278). The subscription price was $100 per share. Upon subscription, the stockholders were given the option of paying the full subscription price, or only $50. If stockholders chose the latter, the company held on to their stock and then sent it out a few months later when the balance, less interest on the amount paid, became due.

The reason for this feature was the tremendous size of the issue and the drain which it placed on funds available for purchase of common stock. By partial delayed payment, time was provided so that additional funds could generate into investors' hands. However, only about four percent of the subscriptions were made on the installment plan.

### *Pricing of Convertibles—Rights and Direct Offering*

We will wind up this chapter, on offering common stock, with a word here about pricing a convertible issue. It involves some of the problems of pricing a common stock.

The pricing of convertibles requires a nice understanding of security markets, and judgment in combining common stock pricing with that of a senior obligation. The figures will be different, but the principles are the same whether they are for convertible debentures or convertible preferred stock. We will explain the principles by a simple example of convertible debentures.

The common stock of our company is selling at $100 per share. The company could sell a non-convertible debenture with a fifteen-year maturity and a 5% interest rate at a price to the public at $100.

If the debentures are made into a convertible, and are convertible on the basis of one share of common for each $100 of debentures, then they would sell at $100 and be on a parity with the stock. Should the market price of the stock go to $90, the convertible debentures would still sell at $100, because they would be worth $100 without the conversion feature.

The convertible debentures would actually sell slightly higher, since they represent a call on the common stock at $100, or in other words, a means to speculate in a possible increase in the price of the stock with a limited risk on the downside, as long as the company's credit is maintained and interest rates do not increase. The extent of the premium over parity with the stock depends on investors' appraisal of prospects for a future increase in the common stock price, and the protection afforded against a decline because of the value of the debentures themselves. Reference to this idea is made in the discussion of convertibles in Chapter V, "Types of Securities." Of course, as the premium price of the convertible debentures goes up, the yield decreases and they become less attractive as debentures.

Since the convertible debentures would be worth at least $100, even if the stock decreased below $100, provided the credit of the company and interest rates did not change, the risk during the offering period is much less than if straight common stock were offered. The debentures put a floor under the price.

With a stock price of $100, it would be possible to sell convertible debentures for at least $100, even if the interest rate on the convertible debentures were set at 4% instead of 5%, because the stock price would hold up the convertible debentures. However, if the interest rate were 4%, rather than 5%, then the floor under the debentures has been lowered. The debentures themselves would only be worth $89.53 on a bond basis alone, in order to produce a 5% yield with a 4% interest coupon and a 15-year maturity. If the convertible debentures were offered at $100 and the common stock price decreased, there would be the risk of decline to $89.53 before the price of the debentures themselves had a stabilizing effect.

What interest rate is established will depend to some extent on the nature of the potential market for the security. Some institutions cannot by law or as a matter of policy purchase a convertible if the price is too dependent on the stock price. Therefore, if such institutions are an important market, it is necessary to set the value of the issue primarily on its senior security value.

As previously stated, setting the interest rate on a convertible and pricing it requires a thorough knowledge of security markets and the exercise of good judgment. The above example was a simple one. All the features of the convertible security, such as call feature, possible delay in convertibility, stepdown in conversion prices, etc., may have some effect on the price. These factors were discussed in Chapter V, "Types of Securities."

Convertibles may be offered either directly or through rights. If it is a rights offering, then after the terms of the convertible have been established, the subscription price is set in a similar way as for a common stock offering. The same general ideas apply as to whether a convertible should be offered through rights or directly, as apply to a straight offering of common.

*CHAPTER IX*

# Investor Relations

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This chapter explains in detail, why, how and to whom a company should disseminate information about itself, that is, any information which will affect the value of its securities. This subject is now well known by the term *investor relations.*

## WHY INVESTOR RELATIONS?

First, what is the purpose of good investor relations?

Years ago, there was a feeling in industry that managements were, in effect, the owners or perhaps trustees of the stockholders' property. There was no reason to give out information about a company's operations. Management was the group which made the decisions. Why, then, was it necessary to bother to keep anyone else informed? This feeling may have resulted from the fact that in the early stages of our industrial growth companies were small and owned by a family or a few people. In most cases, management and owners were one and the same. This situation no longer exists for the companies large enough to have a broad list of stockholders.

Industry today generally recognizes that it is the stockholders who own the company and that managements are working for the stockholders. Managements which persist in the old theory that "we are the company" are out of step with the times. They hurt their companies. They fail to recognize their true responsibility and really render a disservice to our system of private capital, rather than strengthen it.

Management has more than a mere theoretical obligation to its stockholders. Its practical obligation requires a sound investor relations program. A person buys a security at a certain price. The price he is willing to pay is determined by an appraisal of information by the investor himself or his advisor. When he wishes to sell that security, his decision to sell will be made on a similar basis, as will the decisions of subsequent buyers and sellers. The price should reflect as far as possible the risks and potentials present in the stock. It is as important a responsibility of the company that a person buying stock pay a fair price as it is that he receive a fair price when he sells it. Isn't it obvious that those who make such appraisals and determine the market price must be given adequate information at all times?

Furthermore, prices of securities tend to direct the flow of capital. It is not healthy for our economic system to have security prices out of line with the economic risk of the enterprise. It is not healthy for the individual company, in raising new capital, to have a market evaluation which does not fairly reflect the realities of the business. This applies when security prices are too high as well as when they are too low.

In carrying out a program of keeping investors informed, it is essential that management conceive the correct purpose. Otherwise, the goal will not be achieved and managements may become discouraged because of some surprising and irreconcilable reactions from investors. It may be expressed briefly in the following principle:

The purpose of an investor relations program should be to communicate effectively and promptly all information having any effect on a company's securities, whether good or bad, so that those who evaluate securities will have complete information on which to base their judgment.

## MANAGEMENT'S ATTITUDE MOST IMPORTANT

There are going to be times when there will be unfavorable information to give out. For example, earnings may be off, or a major accident may have occurred. Publicizing this information may make a company's securities decrease in price. There is nothing wrong in such an occurrence.

If there are some unfavorable developments about a company which require a reappraisal of its securities in the market, it is foolish for management to assume that it can avoid such action by hiding the facts. The day of reckoning will come. It is far better for the reappraisal to be made by investors when the events happen. An honest, clear-cut picture of the facts will usually help avoid too erratic a reaction in the prices.

Managements can harm their relations with investors if they take wrong attitudes, as illustrated by such statements as:

"The price of our stock has gone up recently, so everything is fine."

"We have nothing favorable to talk about at the present time. Therefore, we will avoid going before the investors."

"Our situation is very complicated at present. Therefore, we will postpone discussing anything with investors until we have matters straightened out."

"Certain information might be misinterpreted; therefore, we will not give it out."

With regard to the first statement, it is a natural reaction for officers of a company to be pleased when the price of the stock goes up. The Financial Vice President should certainly follow the market prices of the company's securities. He should follow them not by themselves alone but rather in relation to the general securities market, and also in relation to securities of other companies in the same type of business. However, they should not be followed for the elation of seeing them go up a point or two. The fact that investors appraise your company every day may be a helpful measure for management to use to evaluate itself on how good a job it is doing vis-à-vis its competition but, again, this measure is only valid when based upon adequate information. Also, you should watch the market prices to see if they are out of line with those of similar securities. If the prices are out of line, they may give a clue that investors are appraising the company incorrectly. If so, the Financial Vice President will want to find out why. There may be need for a stepped-up investor relations program to correct unjustified prejudices. If the stock is relatively overpriced, he might ask himself, is it because other companies are not doing a good investor relations job, or is it because he has given out overly optimistic information?

Managements which take attitudes indicated by the last two statements above in quotation marks fail to realize that if any information is withheld, investors will still have to make a guess about that information. Such a guess is almost bound to result in greater error than if the information is given out freely.

Professionals, in appraising securities, will automatically evaluate a security of a company that withholds information at a lower price than that of one which gives it out. In fact, some of the large investors will actually avoid securities of companies which do not reveal all information. This is not theory; it is a fact. It was stressed by a speaker at one of the Seminars I conducted. He was head of the research department of a leading investment counsel firm. He said: "The first test as to whether we buy a security is the management's attitude towards discussing their operations freely. If they will not do so, we will cross them off our list."

In spite of this fact, some managements do develop a phobia against giving out information. They hold to the idea that certain facts are bound to be misinterpreted. Yes, sometimes they will be. It is up to the management to realize that things will be misinterpreted at times and that there will be unfavorable repercussions. With full disclosure and adequate explanation this can be kept to a minimum. And remember, there will be far less misinterpretation and far better and fairer appraisal of a companies' securities, over the long run, if management can accept some of the apparent disadvantages and realize the real advantages of fulfilling its true obligation to its security holders and our economic system.

### *Advantages*

To be more specific, let's list the advantages of an investor relations program. They are:

1. Generally, it will tend to assure a more reasonable price level for a company's securities. It will help reduce short or violent swings in the market. Lack of information may cause unreasonable fears and induce investors to sell the stock. But with a good information program this can be prevented.
2. It will facilitate raising capital. It will increase the number of investors interested in the company, thus broadening the market for capital. This is directly beneficial to the company and thus its stockholders.
3. It will help prevent unnecessary proxy fights. One of the important tests of good

management, as far as investors are concerned, is its investor relations program. Stockholders will naturally be prejudiced against a company that has failed in this responsibility. If a satisfactory program has been maintained, and a company runs into trouble, then the stockholders will be more inclined to support the management, because they believe in it.

4. It will aid in obtaining approval of necessary changes in the charter and terms in outstanding securities from security holders.

Why should the management of a company expect security holders to go along with requested changes, if it has chosen to ignore them until making such a request?

### *Disadvantages*

There are really no disadvantages to a well thought out investor relations program. However, there are certain obstacles which probably will be encountered.

These are:

1. There are some unreasonable security holders and financial analysts. No matter what you do they may say you are doing a poor job. They may ask and almost demand information which should not be given out. You must handle this group properly.
2. Some information you give out at times will be misinterpreted. Those who receive it may view it differently than you, who know about the entire situation. Don't let this discourage you. It is not serious and can be solved.
3. It will involve some expense and time of the company's officers.

In concluding the above discussion, let us emphasize: Don't undertake a program until you have weighed the above comments carefully. The wrong attitude or lack of understanding on the part of management is bound to produce poor results.

## PROGRAM

In order to do an effective investor relations job, a company should map out a program at least two years ahead. It should be reviewed at the end of each year and extended for another year, with changes made on the basis of the last year's experience.

Why a program and why for two years? A program assures a regular flow of sufficient information, and the use of all necessary media to reach investors. It provides proper spacing of meetings, etc., and prevents duplication of effort. The program should be completely planned for one year in advance and well thought out for the succeeding year. Some media may be used only every two years; thus, at least a skeleton outline is required for the second year, to see how the entire picture will be developed.

A program must be tailor-made to fit the needs of the individual company. There isn't just one correct plan for all companies. The two major factors which will affect the elaborateness of the program are:

1. The size of the company and the number and location of its investors. Obviously, a small company could not and need not have as expensive a program, but it should have an equally thorough program.
2. The nature of the company. A company which is in a very changeable type of business will need to put forth more effort than a company in a stable business.

Is this a laborious task? At first, it seems endless. After one or two years' experience has been gained, it settles down to reasonable proportions. It will take a little time of the president and somewhat more time of the top financial officer. The amount of staff required will depend on the size of the company and its list of investors. Companies which have set up a complete program for investor relations have not found it overburdensome in relation to the benefits. There is no need to jump into an extensive program all at once. A company can feel its way and build gradually.

It may be noted that some companies have found it worthwhile to have a specialist assigned to the proper handling of this task. Such an approach has the following advantages: it relieves the top officers of much of the work involved; it assures a more consistent companywide approach, while the person handling the program can become more acquainted with the information needed by the financial community. This person, in turn, must be completely familiar with all the figures of the company and must be able to present a balanced and comprehensive picture.

## OUTSIDE ADVISORS

Should a company perform this function itself? There are sound reasons why it should.

1. It is more effective, because investors like to know that they are dealing directly with company officials; that they are getting information directly from the "horse's mouth." Furthermore, part of the problem of analyzing a security involves evaluating management. Investors want to become acquainted with the management so that they can appraise it.
2. It gives your company officials contact with the financial community and a background in the general field of finance. If you assign an up-and-coming assistant to handling the details, it is a rare opportunity for training him in finance.

Should outside advisors be used and, if so, in what way? Perhaps, at the start; and perhaps for smaller companies that cannot afford a staff which devotes its entire time to investor relations. However, for larger companies, it is relatively inexpensive to perform the service themselves. Furthermore, it would seem that they would wish to take a personal interest in this function.

If an outside firm is used, it should be on a consulting basis only. Written material should be sent out from the company under its own name. Mail in the envelope of a financial public relations firm may cause an unfavorable reaction on the part of some analysts.

Questions from the investors should be answered by company officials. Consider the reaction of investors if a company official tells an inquirer that the financial public relations firm will handle it.

Suppose your company's program is run by an outside expert who speaks for your company, and at the same time he is also speaking for 20 other companies. Let us assume that one of the companies, which the consultant represents and on which he had given out optimistic information, does not live up to expectations and the information turns out to be faulty. How will that reflect on your company? The stigma of being associated with that financial public relations firm may be felt by all its other clients.

Consulting firms claim that because they are expert in the field, they can do a better job than management. The consultants say that they know just what is needed and whom to contact. They can do it inexpensively, because they can spread the cost over a number of companies. Perhaps they can, but they should not place themselves between you and the investors. They can give you ideas of techniques and assist in planning your program, but management should carry it out.

And, also, beware of what they mean by "better job." Do they mean pushing the price of your stock up? If so, that may work in a bull market. It may be helpful just before you sell stock, but it won't fit your needs during a bear market or when you run into trouble. It can spell failure over the long run.

If an outside consultant is used, be sure, above all, that he understands that he is to do a proper investor relations job, and not a short-term, glamorous one of bulling your stock. The main purpose is to see that more and more investors have a better knowledge of your company. That cannot be accomplished unless the management at least keeps in the act.

## DISTINCTION BETWEEN TYPES OF INVESTORS

Should you treat security holders, such as bond holders and preferred stockholders, differently than you treat common stockholders? Basically no, because it is advantageous to a company and to its stockholders to keep all security holders well informed. Just review the advantages listed above of an investor relations program. Most of them are applicable to all security holders.

Nevertheless, in setting up a program, it is essential to distinguish between two types of investors, no matter what kind of security they own—the uninformed and the informed. They are quite distinct, and the approach to each is entirely different.

The uninformed investors are the great mass of investors who are unskilled in analysis of securities. The informed are those who make a profession of security analysis, and also those who have acquired a sufficient knowledge of securities to make a studied decision as to whether to buy or sell. In order to make sound decisions, two attributes are necessary:

1. A thorough understanding of income statements, balance sheets, different types of securities, financial policy, and a myriad of factors that may affect the profits of a company, including, importantly, management and research.
2. Training in analyzing securities, so that an opinion can be made as to the relative value of one security as compared to another.

## THE UNINFORMED INVESTORS

Let us first consider the uninformed group. There are three schools of thought regarding the uninformed:

1. One believes that they are so hopelessly lacking in knowledge of finance that it is impossible to get across any meaningful story to them. The president of one company, who made extensive tours of the country holding regional stockholders' meetings, tells vividly of how he became totally disillusioned as to the ability of the small stockholders to absorb financial matters. He quotes one woman as saying after a regional meeting: "Mr. President, I didn't understand what you were talking about, but I just know there must be something wrong if you came all the way from New York to Chicago to talk to us. Can't you tell me if I should sell my stock in your company?" After numerous other similar experiences, he concluded, "Don't waste your time on the uninformed."
2. The second school of thought is that the uninformed investors should be given as much as seems reasonable for them to absorb. They are not specialists and do not have the time or training to analyze securities carefully. So do not burden them with volumes of statistics. But don't neglect them; rather, send them periodically a few facts in simple terms.
3. The most optimistically minded contend that our capitalistic system cannot survive unless the great mass of the people are helped to understand how our economy works. For example, they urge that much emphasis be placed on appealing annual reports and that they should be used extensively as an educational media. The optimists say we should use every means possible to get stockholders to understand our system of private capital.

One of the most practical studies I have seen on the uninformed investor was made by The Controllership Foundation, Inc. It was entitled, *What Information People Want about Policies and Financial Conditions of Corporations.* The late Dr. Julian Woodward, Research Executive, Elmo Roper & Associates, played a major part in that survey. He personally interviewed many stockholders. The writer heard him many times present his findings on the average stockholder. His conclusions were that most stockholders just do not have sufficient knowledge about finance to understand income statements, balance sheets, complicated annual reports, etc.; that in most instances they bought securities on the advice of a professional—a security analyst, a broker, a banker, or an investment advisor.

It seems that the second school of thought, or the middle course, makes the most sense. Those who take the first approach may be overly pessimistic. Those who take the last seem to be working towards a rather long-term goal as to what their audience someday should be like. Certainly no one should be criticized for this kind of worthwhile effort to get the public better informed about our system of private capital. There is no question that it is woefully needed. If it can be achieved by efforts with the small stockholder, so much the better. This is somewhat outside our immediate problem of informing stockholders specifically about the company.

Getting back to our theme, it was Dr. Woodward's contention that the average stockholder wants to know just three things about a company:

1. Dividends per share;
2. Earnings per share;
3. A general statement about the strength of his or her investment.

The ideal place to cover this information is in the annual report. It should be in the very first part of the report and in easily read type. Even the informed investors are interested in these things. It is rather amusing to find some annual reports where these most important items are stuck away in the back. Why? That is always a mystery.

The President's Letter, which appears in the front of the report, is an ideal spot to make a brief statement of the general strength of the company. In some annual reports, the President's Letter is written in very small, hard-to-read type, smaller than the type in the rest of the report. Why? Is it done to fit the material into a page? If so, it is no excuse. Too small type is annoying and discourages reader interest.

If some space is to be devoted to the uninformed stockholder, it is essential to make certain that the audience is reached. Visualize a small stockholder who owns ten different stocks and receives ten elaborate, complicated annual reports. Do you expect him to read all of them? If he reads part of each, he will be doing well. The first thing that should be done in order to get him to read even part is to make the report very readable. This also applies as far as the informed investors are concerned. It is interesting to test annual reports for readability. Try the Rudolf Flesch test, *How to Test Readability*.[1] You will be surprised to find that many annual reports, even those directed specifically at the uninformed, fall in the hard-to-read category. A glamorous report with nice pictures and charts in themselves won't make stockholders actually read it. Charts should be used as an integral part of the story in order to increase readership and understanding.

The various annual report "awards" have done a great deal to stimulate companies to do a better job. However, some managements have been carried away by the idea of winning an award. They seem to feel that this means they have accomplished their goal. But too much emphasis along these lines may prevent a company from keeping its eye on the ultimate audience to which the report should be directed. Write the report for the correct audience—your own shareowners and other investors. If an award results, well and good.

This discussion is not meant to imply that the annual report is written just for the uninformed investor. It should be directed to all types of investors. A more thorough discussion of the annual report will be given later.

We have drifted somewhat off the subject of supplying information to the uninformed investors by pursuing a discussion about the annual report. There are various other media you may wish to use in order to cultivate the uniformed investor. Don't take these as recommendations, but merely some possibilities you may want to look into:

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[1] Published by Harper and Brothers, 1951.

A post-meeting report on the annual meeting;
Letters of welcome to new stockholders;
Letters to stockholders when they sell the stock;
Letters in response to complaints;
Letters of thanks for sending in proxies;
Dividend stuffers;
A small sample of your products if your business is such that you can do it—say, a company in the food business;
A small booklet on understanding your company;
Regional stockholders' meetings.

Remember the three essential factors to stress—dividends, earnings and the general condition of the company. Don't talk over the stockholders' heads, but don't "talk down" to them either.

Letters from stockholders should be answered quickly, courteously, and as fully as necessary to give a good answer. As stockholders they have a right to question. Even an unreasonable request deserves an immediate answer.

American Telephone and Telegraph Company, with about one and three quarters million stockholders, has set up a program to reach as many stockholders as possible through personal contact. Management personnel in their subsidiaries throughout the country are trained on the type of information stockholders might wish to know. Visits are made as a part of the day-to-day jobs of these telephone people. Over 150,000 stockholders, who were chosen on a random basis, were visited in the first four years of the program, and it is continuing at a steady pace. This can't help but assist in a better appreciation on the part of their stockholders of the company's objectives.

The type of cultivation required for the uninformed stockholder is more a part of the general problem of public relations. It is most important for you to distinguish between the types of investors. What might seem completely right to the uninformed might appear foolish to the informed; what might be interesting and informative to the informed, might be incomprehensible to the uninformed.

As previously noted, the writer believes in a middle course towards the uninformed. Don't by any means ignore them. However, they cannot be expected to use complex information to arrive at a definite conclusion regarding a security. I do not wish to dwell longer on the uninformed, because I feel that the most important audience to cultivate is the informed investor. However, before leaving this group, a word of caution should be added. A college professor, who was a finance teacher, was heard to complain that there should be no distinction between the uninformed and the informed. He objected strenuously to not receiving all information about companies in which he has an investment. He had a right to object. Furthermore, there may be many small investors, not professional analysts, who do their own analysis work in deciding what securities to buy. They want all information, and they should receive it. Keep this in mind when setting up a program. All information should be made available to anyone who wants it. For some companies, such as railroads, utilities and certain types of industrials, where much additional statistical information is publicly available, this can be handled quite readily by including a statement in the back of the annual report. This statement would explain that the company sends out this kind of additional information and would be glad to include any security holder who might wish to receive it. However, don't be alarmed. Companies which have asked the great mass of stockholders whether they wish the additional information have received only a very few requests. The note included in the annual report to the effect that information will be sent acts as a precaution to prevent someone from having a justifiable complaint.

## INFORMED INVESTORS

The informed investors are the primary ones who determine the market price for your securities. As stated above, they have the ability and training to evaluate securities. Furthermore, the uninformed largely rely on the informed group for advice as to what action they should take. By giving complete information to the informed group so that they can make sound decisions, you are directly benefiting the uninformed investors.

### *Security Analysts*

More specifically, to whom do we refer by the term *informed investors?* Primarily to the security analysts who are regularly engaged in careful study of all the factors which have an effect on individual securities. They are the individuals who make recommendations on the quality of securities and on whether to buy, hold or sell them.

Security analysts are found in practically all types of organizations which are directly engaged in investing money or in recommending to others how they should invest—in investment companies, investment counsel firms, investment banking firms, personal trust departments of banks, mutual funds, pension funds, open- and closed-end funds, insurance companies, savings banks, brokerage houses, rating agencies, etc. They are the ones who make up the department in these organizations which is referred to as the research department, the statistical department or the analytical department.

The security analyst may not always be the one who will make the final decision whether to buy or sell, or have the contact with the customer. For example, in an investment company, that decision may be made by a committee. In a brokerage house, a registered representative, or so-called customer's man, may talk with the client and suggest what action to take. However, it is most important in setting up an investor relations program to realize that behind the scenes it is the security analyst who pores over the information about your company. It is he who makes the original recommendations on the action to be taken. He is the one to whom a company should send its information. A failure to realize this point will cause a company to direct its efforts to the wrong people. For example, one company comes to mind which gave a luncheon in Boston for the purpose of telling the story of its operations. It invited the top officials of various types of financial organizations. They turned out, apparently, because they did not want to say no to such an important company. The company was quite elated because of the high caliber of those who attended. However, relatively little good resulted from the meeting. The officials took no notes, nor did they tell their own security analysts any of the facts given out at the meeting. The security analysts were heard to grumble, and rightly so. In their eyes, the company actually hurt itself by showing that it did not know who did the work on its securities.

This is not to suggest that in many organizations security analysts have not attained top positions. There are many who are partners or vice presidents. However, be sure that you direct your efforts to them and not to some officer just on the basis of his title. For example, letters are sometimes sent to presidents of banks inviting them to a luncheon at which a company wishes to tell the story of its operations. Perhaps the company does not know whom to invite. If so, the letter may be directed to the president, but it should read, "We would like to have as our guest the person in your organization who is interested in analyzing the securities of our company."

You may wish to do some top executive cultivation in the financial community as a part of your investor relations program, so that the name of your company will become better known in top financial circles. This, too, is part of your investor relations program, but you should not confuse it with the problem of getting information across to those who actually study and use the information.

Another example of the importance of knowing where to direct your efforts occurs in the case of the commercial bank. There are persons in the commercial bank who are interested in your company from the point of view of the regular commercial banking business—loans, deposits, corporate trust, etc. There are others in a bank who analyze your securities as a media for investment in the accounts managed by the personal trust department. In most instances, the commercial man does not pass on the information he receives to the security analyst in his bank. They are in different departments, very much separated, and they should be. Because of the importance of this point, let me here digress a bit.

Visualize the reaction of a person who employs the personal trust department of a bank to give impartial advice on investing his funds. Suppose that person found out that the bank bought securities of certain companies in the personal trust accounts in order to influence those companies to do commercial banking business with it. There might be good grounds for a law suit in such a case. The commercial banking and trust department must be absolutely and completely separate. Some companies have made the mistake of opening deposit accounts with commercial banks merely because those banks held a large amount of their securities in personal trust accounts and pension funds. This may have been due, in some instances, to the fact that representatives of commercial banks have indirectly hinted that because the personal trust department holds a large amount of securities, it would be well to do commercial banking business with the bank. Anyone who makes such an intimation should be told that the recipient is not quite that naive.

Keeping the commercial bankers, who lend you money, informed is quite necessary, but it is more of a separate operation. It might serve a purpose to include them in meetings with security analysts and send them the same information; however, their different interest in your company should be recognized. Reaching them will not substitute for covering the security analysts in the same organization.

Getting back to the security analysts, there are all degrees of experience and specialization to be found among the analysts. In experience, they range from beginners to those who have spent many years in the field. A company is naturally most interested in reaching the knowledgeable analyst, no matter what his age. Since an investor relations program must be a long-term project, the inexperienced analysts should also be included, because the earlier they get to know about your company, the better.

There is a wide variation in specialization among analysts. Some firms handling a large volume of investments may have a sizable analytical staff, divided into different industry groups, with one or more analysts working on just one group—such as utilities, rails, oils, chemicals, etc. On the other hand, small investment firms may have only a few or even just one man doing analysis work on interesting situations as they arise. In fact, in small brokerage houses, the partners who do the brokerage work also may be doing analytical work. They should be included, if they are interested in your company, just as much as the specialist.

With all this about "Who is who?" among the analysts group, you may conclude that cultivating the analysts is a hopeless task and that it is very difficult to seek out the ones who are actually interested in your company. Not at all; it is relatively easy. The number of analysts to be kept informed even for a large company is only a small fraction of the number of its stockholders. And the analysts can be located with reasonable effort.

### *The Analysts' Societies*

As described in Chapter VI there are 6,300 individual members in 23 local analysts' societies throughout the country in the principal cities, including two in Canada. They are tied together through the National Federation of Financial Analysts Societies. A Directory[2] is compiled each year giving the names of members of all the individual societies. Only a part of this total would be interested in the securities of a particular company. The total membership includes all types of analysts—railroad,

[2] See Chapter VI, page 186, for information on obtaining a copy of the Directory.

utility, industrial, municipal bonds, etc. Furthermore, the membership requirements of the societies are not uniform and there are many included in the list who are really not security analysts. There are some who work for industrial companies, service organizations, and so forth. The members of the New York Society are coded in the Directory as to the type of industry in which they are primarily interested. This coding is not altogether complete and should not be fully relied on. Outside of New York there is less specialization, because the firms tend to be smaller, and there is no coding in the Directory. Not all analysts are members of the Societies; therefore the Directory does not give a complete list.

### *Building a List*

How, specifically, can you build a list of analysts who are interested in your company?

First on your list should be the institutional holders and large owners of your securities. Study your stock and bond records for this information. You can find out readily who should be on the list in each such organization by a simple letter. The letter should state that you wish to know who is interested in analyzing the securities of your company, and to whom written material should be directed. Sometimes large organizations prefer that you send material to their library.

There are three organizations in New York which should be next on the list of every company with securities publicly held. They are the rating agencies—Fitch Investor's Service, 120 Wall Street; Moody's Investors Service, 99 Church Street; and Standard and Poor's Corporation, 345 Hudson Street. These organizations are such an important part of the financial community that they are described separately in Chapter VI. It is necessary to understand thoroughly what they do, what they want to know about your company, how to furnish information to them and how to handle your relationship with them. These matters are covered in that chapter. Suffice it to repeat here that their ratings of publicly held securities have an important bearing on the quality and price appraisal by most investors; and their many publications, which are used almost universally by analysts, may be as important in furnishing information about your company as the material you send out directly.

It was stated above that a majority of analysts throughout the country are members of their local financial analysts' society, and that these societies are members of the National Federation. A good method to use to determine who is interested in your company is as follows: After you have given a speech about your company before one of the societies, send out a return postcard to the entire membership of the National Federation of Financial Analysts' Societies. Ask those who wish a copy of the talk and who wish to be placed on the mailing list to return the attached postcard. This can be handled very easily and at relatively little cost by using the up-to-date address plates maintained by the mailing house facilities (Ace Press and Letter Company, Inc., 61 Whitehall Street, New York City) of the National Federation and the New York Society. The mailing house will send out the card for you at a nominal charge. The number of return cards you will receive will depend on the nature of your company. A large company might receive a 20% return. Don't use the Directory for this purpose; it is not corrected for current changes.

To build a list of non-members is not quite as easy. You may ask an underwriting house that is familiar with your company to suggest a list of names of persons who might be interested. Write directly to these persons and ask if they wish to be included. You may wish to refer to directories of certain types of large institutional investors as a source of names.

You now have a list started, and you should use every opportunity to build it. For example, when you appear at a meeting of an analysts' society, be sure to have cards available which the audience can fill out. If new names appear, write those persons a letter asking if they wish to be added. The same applies when you have a Due Diligence Meeting prior to the sale of your securities, or other similar types of meetings.

For some industries, there are groups of analysts who meet on an informal basis to discuss problems of that industry. At some of their meetings they have industry representation. If your company is in such an industry, you should know about these meetings and who attends, as they represent the core of specialists in that field.

There are many other types of people who should be prominent on your financial list. If you are listed on a stock exchange, there is the specialist assigned to your stock on the trading floor. Get to know him personally.

As you develop a list, you will encounter some special situations which exist for some types of investors. For example, one organization may manage the investments for more than one investment company. You will only need to cover one analyst for all the investment companies in the group. The same idea applies to the fire and casualty insurance companies; there may be a number of different companies in one group. These special situations will become apparent as you become more familiar with the financial community.

### *The Security Dealers*

If your securities are traded over-the-counter, a worthwhile group to know about is the security dealers who make a market in your issues throughout the country. Find out from some dealer the list of firms that are included in the quotation sheets published by the National Quotation Bureau, Inc., 46 Front Street, New York City. This firm was referred to in Chapter VI (page 143). The importance and position of the dealers should be thoroughly understood. You will wish to consider sending written material to them, holding meetings, the effect of loss of dealer interest when a stock is listed, etc. Payment of soliciting dealer's fees is covered in Chapter VII. Be sure to include them in your investor relations program, particularly if your stock is over-the-counter.

### *Review your Mailing List*

Having now started a list, you should comb it to make certain that you do not have duplications, with too many people from one organization, etc. The best example of this of which the writer is aware occurred in a small investment advisory firm. Four members of the firm were members of the New York Society of Security Analysts, Inc. At various times each had signed cards given by a certain company saying that they would like their names added to the mailing list. Neither knew the others had signed. The company thus sent four sets of material to the firm consisting of four people, all in the same office. This was quite a waste for all concerned. An annual review of the mailing list should be used to iron out such duplication, to take care of changes of address and title, and so on. The annual review letter should include:

1. A statement that the company is pleased to have the person on their mailing list; that it hopes all desired information is being received; and that if further information is needed, the person is invited to write or telephone, or call in person. Be sure to indicate which executives should be contacted by the analysts.
2. A list of those who are being sent the information in the same firm. Ask whether all the names should be continued or any added.
3. A request to make any changes in titles or spelling, etc.
4. A return, stamped postcard to cover the information above.

Some companies apparently do not feel that it is necessary to develop a mailing list. They follow the policy of sending their annual report to all members of the analysts' societies. The number of annual reports that get thrown in the waste basket each year in the financial community is phenomenal. That is a real waste of stockholders' money. A company should know which analysts are interested. One of the largest manufacturing companies discovered that most analysts get their annual report as a result of the general mailing to stockholders, and arranged their mailing to analysts to prevent duplication.

Now what do we do for the analysts in order to give them all the facts?

### *How To Tell What Analysts Want*

Don't sit back in your office and try to imagine what the analysts want and how they want it. There may be great mystery as to what the uninformed investor wants, and you may never know the exact answer. Surveys on the uninformed investors seem to differ widely. However, with the informed group you don't have to guess. You can hit the bull's eye just by asking. You should have close contact with at least five top analysts representing different types of organizations. They can act as your listening posts and tell you what information they want. Don't use just one analyst, because each analyst has special methods of approach, and special likes and dislikes. You will not reach the needs of most analysts if you rely on one as a guide. Five analysts ought to give you a good cross section and their ideas should be representative of the analysts as a whole. Be sure that you explain your objective carefully and make certain that they understand that you are seeking criticism and suggestions; otherwise, they may take the easy way out by flattering you rather than being critical. This isn't something to be brushed aside lightly, or you will get poor results.

Let's take an example. An industrial company had followed a policy of designing its annual report for the financial analysts. However, the company had always written it in their offices 1,000 miles away from any major financial center. They thought they had the information the analysts would like. The writer suggested an experiment: give the latest report to five analysts, ask them to review it and subsequently have luncheon with the financial officer of the company. At the luncheon, the analysts could suggest what should be added or deleted. The Financial Vice President gave it a try. Many constructive ideas were made. The analysts did not expect the company to include all their suggestions, but the company's next annual report did a far better job. The same principles apply to testing other media of cultivation, such as a statistical book or ideas to include in a speech, at a meeting with analysts.

Now let's go over the different media that are available to a company. As pointed out, how much and what is used will depend on the type of company, its size and other special characteristics. Remember, design everything to fit your audience by first getting their reaction. It is well to divide the media into two types—personal contact and written material.

### *Personal Contacts*

*Financial analysts' society luncheons*—Companies probably achieve the most personal contact with security analysts through appearance at the regular luncheon meetings of the New York Society of Security Analysts. The notice for the meetings goes to all the 2,500 membership, but attendance ranges from 100 to 300. Of the total membership, many specialize in certain types of securities and do not have an interest in securities outside of their field. Generally, small or closely held companies do not appear on the program, because there is not enough interest.

The Program Committee of the New York Society is divided into subcommittees which cover industrials, railroads and utilities. These subcommittees arrange the program for one year at a time, from July to the next July. In most instances, companies are invited to appear. However, if the management of a company feels that it would like to be included and has not received an invitation, it should contact the Committee and inquire whether arrangements can be made. The company should feel no compunction whatsoever about asking. The program includes the top companies in the country and fills up so fast that a company should ask for a spot at the beginning of the year in order to be included. If the Committee should decide that there would not be sufficient interest at the time, the company should not feel hurt. It merely will have to use other media to get its story across.

The other societies are much smaller than the New York Society, and their membership is somewhat different in character. Their meetings are less frequent. If a company wishes to appear at their meetings, it should make it a point to find out how they operate.

*Luncheon given by company*—At the analysts' societies' luncheons, the companies are the guests. A company may decide to give a luncheon on its own for the security analysts rather than appear at one of the societies' meetings for the following reasons:

1. It may wish to include non-members; there are numerous analysts who are not members.
2. The societies' programs may already be filled.
3. It may wish to alternate between the society's and its own luncheon for variety.
4. It may not be large enough to be included on the program.

If it does decide to give its own luncheon, it should have a good reason for doing so, because the societies do represent an excellent media for promoting good relationships with financial analysts.

There are a number of ways to handle these luncheons. The company can give a large luncheon for as many as 200, or a series of smaller ones. The latter give the company officials a better opportunity to get to know the individual analysts personally, but they are more time-consuming.

One of the problems which arises in connection with giving a luncheon for analysts is the invitation list. If a company doesn't have its own list, it will have to try to get suggestions from an investment banking firm or commercial bank which is familiar with the analysts who might wish to attend. A company may also want to send invitations to all the members of the local society. If this is done, caution should be used not to include anything in the invitation intimating that the luncheon is under the auspices of the society. If invitations are sent to such a large number as the membership of the New York Society, it will obviously be necessary to have return cards so that the company will know how many to expect. Additional planning is necessary to keep things under control.

It is possible that more acceptances may be received than can be accommodated. In order to be able to handle such a possibility, the letter of invitation should state that if the number of acceptances exceeds the capacity of the luncheon room, then selection will be made on some defined equitable basis, such as one person to a firm, first acceptances considered first, etc. Those who cannot be accommodated should be sent a letter of explanation, and an alternative should be given to them so that they can hear the same story. It should be remembered that analysts dislike very much being excluded from a luncheon if they have sent in a reply card that they will attend and have a real interest in the company's securities. Don't be too exclusive in your invitations, but don't be so apprehensive of offending someone that you hesitate to hold a private luncheon.

*Receptions*—After you have presented your story at an analysts' society or given a large luncheon, you may wish to hold a reception on the afternoon of the same day. At a large luncheon you have an opportunity to tell your story and answer some questions; however, you cannot speak to all analysts personally, and a reception affords this opportunity.

There are some details which should be followed in order for a reception to be effective. They may seem obvious, but enough companies miss them to make them worth mentioning. In New York, we feel it should be held from about 4:15 to 6:00 P.M. This gives those who wish to catch a 5:15 train an opportunity to drop in, and also allows time for those who can't leave the office until 5:00. It should be held in a place convenient to the financial center. At least four officers of a company should be present so that if 100 or more analysts attend, there will be adequate coverage and the analysts won't spend the time talking with each other. One company representative could be assigned the job of making certain that the officers circulate so that all analysts will be covered. Some analysts may monopolize an officer. The officers should have name tags including their titles as it is embarrassing to talk to an official without knowing his position. You may wish to have name tags for the guests as well so that your officers will know with whom they are talking.

Invitations should be sent out saying who will be present from the company, with a return card so that the company will know how many expect to attend. It is not sufficient to issue an invitation at the luncheon held on the same day. By that time many of the analysts may already have accepted other engagements.

If a company has already told its story at a regular luncheon meeting of an analysts' society, it is unnecessary to repeat the story again at a reception in the afternoon. There may be an exception when there were some who could not be accommodated at the luncheon. Then the company may repeat the story before the reception. The invitation to the reception should make this item of the agenda clear, so that those who have already heard it will not have to sit through it again.

If a company does not hold a luncheon, it may hold a general meeting in the afternoon and tell its story the same way as it would at a luncheon. Timing is important. It should not be too early, or else there will be poor attendance. It should start at 4:00 P.M. This method has an advantage in that a larger number can be accommodated than could be included at a luncheon, and there is no need to have as close account of those who will attend. The principal disadvantage is that people may wander in late and miss part of the talk, which would not happen at a luncheon.

With regard to invitations to an afternoon meeting, they should be handled similarly as those to a luncheon, but because of the greater number that can be accommodated, the invitations can be sent on a much broader scale. In addition, invitations might be issued to the security dealers, already mentioned. A company might even include an advertisement in financial papers announcing the meeting. If it is done on such a broad scale, those answering the advertisement should be requested to write or telephone the company giving the reason for their interest. Then tickets should be issued to those who request to attend. This will help reduce freeloaders. In any of these large meetings there are bound to be a certain percentage of freeloaders; a company must accept that as inevitable.

*Due Diligence Meetings*—When a company offers securities at competitive bidding, the general practice is to hold an open meeting in the financial community in which most prospective bidders will be located, generally New York City, Chicago or Boston. It is advisable to hold it at a place convenient to the financial community. Most often, if a company does not have an office in New York, the place is a conference room in one of the commercial banks with which the company does business. It is conducted by the executives of the issuing company, but also will include lawyers, accountants and perhaps technical experts.

The announcement of the meeting is made in the advertisement for bids. Some companies, in addition, send a letter to the analysts on their list, telling them of the meeting. Whether or not the letter is sent, many of those who attend will be analysts.

This meeting is referred to by the term *Due Diligence Meeting* or *information meeting*. It is not a legal requirement of the Securities Act. It grew up as a matter of practice. Its purpose is to give prospective bidders an opportunity to meet with company officials and make sure that they have used "due diligence" in obtaining all information affecting the securities which will be sold to the public. Underwriters are subject to certain penalties under the Securities Act if they fail to use due diligence in investigating the securities. A thorough analysis of a company generally should include a visit with the management to clarify any questions which may arise about the company.

This meeting may be held in the morning or afternoon. In setting the time, it is important not to have it conflict with Due Diligence meetings which may be held by other companies offering securities. A conflict may reduce the audience for one of the companies.

It should be held about five days before the bidding date, so that there will be sufficient time to use the information in arriving at the price to bid. Some companies have made the mistake of holding the meeting one or two days before the bidding. By that time the bidders have already completed their analytical work. The meeting includes a coverage of the prospectus and time for questions. The company officials should take the opportunity to tell the same story as it would at a meeting with analysts.

The practice evolved for companies to use this meeting as an opportunity to cultivate the financial community. In other words, they included the Due Diligence Meeting as part of their investor relations program. Thus, in order to win good will, the company officials made more out of the Due Diligence Meeting than a mere formality. This proved advisable, since many people who attended the open meeting were not necessarily interested in the particular security being offered, such as a bond, but were there to get information about the company which would help in analysis of all the company's securities.

If a company has told its story at an open meeting with analysts in the same financial community within a reasonable time or expects to have such a meeting in the not too distant future, then presenting a complete story at the Due Diligence Meeting may result in duplication. Duplication of effort through Due Diligence meetings and analysts meetings should be eliminated through proper programing.

Some companies feel that it is preferable to treat the Due Diligence Meeting as strictly a routine matter and not try to make it a part of their investor relations program. They limit the meeting to a review of the prospectus and a question period. Their argument is that the people who attend are relatively limited and not necessarily those who would be covered as part of an investor relations program. This may be a poor procedure and may build ill will in the financial community. Those who attend generally expect something more than just a routine review of the prospectus. What a company should do will depend on what else it does in keeping investors informed. The company must weigh the possible adverse reaction on the part of some people who attend if it is made strictly a routine matter.

A possible substitution for a Due Diligence Meeting is to advertise that company officials will be available at a designated place on a certain day for a period, say, between 10:00 A.M. and 4:00 P.M., during which time the officials of the company will answer questions. Interested persons may call for an appointment or just come and wait their turn. This method has certain advantages and disadvantages. The company knows the individuals with whom it is talking, and it assures that any unauthorized statements will not appear in the press. The method has the disadvantage of preventing an open discussion of the company's situation. Some of the questions one person asks may turn out to be of interest to the others who would attend an open meeting. This latter practice started to be used in 1957 by some companies after the Securities and Exchange Commission investigated certain companies for information given out about new offerings which got into the press, but was not given in the prospectus.

A company will have to use caution about the type of information it gives out around the time of a sale of a security, to any investor or prospective investor. As was discussed in Chapter VI, the Securities Act of 1933 limits such information. The Securities and Exchange Commission has taken a rather strict approach to this matter. In your personal contacts with investors during this period, you will have to explain why you are under wraps and are limited in what you can say. This explanation will have to be handled tactfully, because it is not appreciated by some investors. The value of a meeting with security analysts around the time of a sale of a security has been largely limited by this factor. This provision of the Act does not apply to giving information to potential underwriting firms, provided they do not turn around and pass it on to dealers and investors.

If a company's securities are offered publicly through a negotiated financing rather than competitively, the principal underwriter will undoubtedly wish company officials to discuss its operations with members of the underwriting group. This is a closed meeting and is run by the head underwriter. Attendance is limited. For this reason, it may play a less important part in an investor relations program.

*Dinners*—Dinners are not very effective because of the problems of getting people to attend, due to the commuting problem. Dinners may best be used for a small, special group. There are exceptions. The New York Society of Security Analysts has arranged some very successful dinner meetings with large companies.

*General considerations regarding meetings*—How often should some form of large meeting be held in an important financial community? This depends on the nature of the company and the problems of the analysts in keeping informed. If its operations are subject to change, if they are complicated in nature and require a lot of explanation, then as often as once a year may be necessary. For a stable company, every two years may be sufficient. The frequency of meetings should also depend on other factors than stability. How large is your company? How well are your management policies known throughout the country? Is yours an easily understood type of operation?

Variety may be injected into the program by using different types of meetings. However, coverage is most important and don't attempt to achieve variety if it results in any loss of coverage.

It is worthwhile to stress again that a company should be meticulous not to have its meeting conflict with a meeting held by a similar type of company, so that analysts who may wish to attend both will have to make a choice. Both meetings suffer as a result of these conflicts. The program for the analysts' societies can be readily determined by checking with a committee member. Dates of other Due Diligence meetings, luncheons, etc., can be obtained by asking a leading underwriting house to check for possible conflicts. There are some times when meetings can't be held successfully, such as when a local analysts' society is having its annual outing or the local members are attending the national convention. Check with well informed analysts to avoid such conflicts.

*Special types of meetings*—There may be new ways to present your company's story. Socony Mobil Oil Company got the idea that junior analysts in the New York area might be interested in a course in the analysis of oil companies' securities. They set up such a program, with the top men in various phases of their company's operations as speakers. It turned out to be such a success that senior analysts clamored to be included and the company had to repeat it many times. It was also held in four cities outside New York. While the course was directed on the subject of the oil business in general, it won many friends for Socony and provided a better understanding of its operations on the part of investors. Some other large companies with operations hard to analyze adopted the idea.

*Trips and plant visits*—Visits to a company's properties may prove to be an excellent medium to use in order to give analysts a thorough knowledge of a company's operation. Such trips should not include too many guests, otherwise there is not sufficient opportunity for individual attention. About 25 guests is a good number, depending, of course, on the nature of the trip. This necessitates having a series of trips in order to cover a large number of analysts. However, such tours can be spread over a long period of time so as not to put a burden on the company's staff. There may be situations in which trips can be arranged for four or five analysts, depending on what is sought to be accomplished. In a few instances, trips for large numbers have been most successful, but don't try to do a mass job just for the sake of coverage.

Top personnel should be available for a substantial part of the trip, so that analysts can get a view of the management and have their questions fully answered. The financial man should be on hand at practically all times. On one particular trip the analysts were handled by salesmen. They did a good job in explaining the product, but were totally lost on all financial questions. The analysts received a very unfavorable impression of the company. Another reminder: don't wear out the analysts so that they can't absorb what you show them. On the other hand, don't make it a junket. You will lose their respect. It should be a working session, so that when it is over, the analysts will feel that they have made a worthwhile addition to their knowledge.

A trip has the advantage of so thoroughly acquainting analysts that they will tell other analysts about your company's operations. Thus, the benefit is not limited to just those who go on the trip. Furthermore, once they have been on a trip, there is no reason to include them on another. They have a lasting knowledge of your company. Other types of cultivation, such as luncheons, do not have as lasting an effect and must be repeated regularly.

*Personal calls and Individual contacts*—Certain organizations and large investors may deserve personal calls. See the section in Chapter VI which covers the rating agencies; they may be high on the list for most companies.

How far you can go with personal contacts depends on your location in relation to the large financial centers. Some companies make it a practice of keeping a list of large investors, such as insurance companies, investment companies, large individual holders, etc., segregated by cities. Then, when one of their senior officers is in one of the cities, he calls on them.

When the financial officer of the company is in a large financial center and finds that he has free time, he might invite five or ten analysts to join him at an informal luncheon. This can result in a two-way benefit. The financial officer can check with these analysts on their feeling towards the company and its program to keep them informed.

Your personal contacts with the well informed analysts represents one of the best ways of keeping a complete story about your company before the financial opinion makers. How far you can go in this regard depends on the circumstances surrounding your company.

*Presentation by a company*—All types of formal presentations before a group of analysts—at luncheons, Due Diligence meetings, etc.—are basically similar and there are certain rules which should be followed.

It is not so important whether one man does the speaking or a team approach is used, so long as the speakers are senior officers who can speak with authority for the company. If one man speaks, it generally should be the President or the Financial Vice President. Due Diligence meetings which are held in connection with an offering of securities at competitive bidding should not be conducted by an outside lawyer. It gives the impression that outside counsel really runs the company. In special situations, there may be a place for men in production, research, etc., to explain an important part of a company's operations.

A careful observation of timing is essential. Nothing will defeat the effectiveness of a meeting more than too long a talk. A good rule of thumb to follow for a regular meeting with analysts is a 30-minute talk and 30 minutes for questions. A pause between the talk and question period gives those a chance to leave who may have to return to their offices.

Even if more than one person talks, no more than 40 minutes should be taken for the formal presentation. At a luncheon, remember to finish everything by 2 o'clock. People have to get back to their offices. If there seem to be too many questions, then close the meeting at 2:00 and suggest that anyone who has more questions may stay after the close.

What to cover will of course depend on each company. However, don't waste time on history. Analysts are familiar with the background material on your company. They are interested primarily in those factors which will affect the future. What are the problems the company has to face, and the favorable developments? They will be most interested in items which will eventually affect the balance sheet and income statements.

Expansion requirements and methods of financing are most important. Particularly, cover factors about which the analysts may have unjustified prejudices or may not understand. If something is said about earnings per share and dividend policy, it should be saved for last. We will subsequently comment on how to handle forecasts of earnings and dividends.

One of the important factors analysts are weighing when they hear the management of a company present its story is the quality of the management itself. It will be judged on the manner in which it presents its story as well as what is included. Analysts realize that within economic limits, the company is dependent on the quality of its management if it is to prosper.

If a company has appeared recently before the same group of analysts, it may wish to vary the type of material presented. However, be careful not to develop such a novel approach that the analysts will receive the impression that the company just doesn't have a firm understanding of what makes securities sound. A standard type of approach, even with the risk of being repetitive, is the safest and will produce the best results.

Talking from notes is preferred to reading a speech. Enthusiasm in a talk before analysts is naturally to be desired. However, it should be based on facts and actuality. Occasionally, the president of a company will go too far in terms of unrealistic "dreams." This definitely creates an unfavorable impression unless the "dreams" are clearly labeled as such.

There are various aids that may be used in presenting a story. What is used will have to depend on the preferences of the person who gives the speech. Beware of the use of wall charts or slides. They may seem attractive to the management, but a chart is no good unless all the audience can see all of it, including the bottom line. The bottom line is one of the two scales and if it cannot be read, the chart loses its significance. Have you ever sat in a room with more than three or four rows of seats and visualized how high a wall chart must be in order for the person in the back row to see the bottom line? My experience has been that much of the audience at meetings of analysts have failed to see all parts of the charts and slides presented by most companies. If you do use charts, have someone inspect the meeting room ahead of time and design the charts and the stand so that everyone can see them.

One way to solve the problem of using charts is to print them in a small booklet which can be handed out to the audience and referred to by the speaker. This has three advantages: it can be easily seen, the audience can make notes on the charts as the speaker talks, and it can be filed for reference purposes. It has one disadvantage: the audience may thumb through it during the talk and not give full attention to the speaker. The advantages seem to far outweigh the disadvantages, as compared to wall charts or slides.

Films showing a company's plant or operations may be effective if they are brief shots and do not take too much time. A full length film may take away from the time allotted for the talk. The full-length film might be fitted in by showing it during the lunch hour prior to the talk, or a film might be used at a reception just prior to the social part. If so, it should be announced in the invitation. Do not use the film, whether it be long or short, unless it really adds to the presentation and can be properly fitted in.

Even if the speaker does not read his speech, it is well to have copies available to distribute after the meeting. This guards against misunderstanding what the speaker has said. Furthermore, a card or letter can be sent to the entire membership of the National Federation of Financial Analysts' Societies, asking if they wish a copy. This is an excellent way to get wide distribution of the talk, and, as previously stated, at the same time build up a mailing list of those interested in the company.

If a company is scheduled to appear at an analysts' society in another city in the near future, it should wait until after that appearance to broadcast copies. Otherwise, the story will already have been read by these analysts. Copies of the speech should also be sent to all those already on the company's mailing list.

If a company does not have copies of the speech to hand out at the end of the meeting, it may wish to have copies of a few pages of the material covering subjects which are difficult to explain, such as earning adjustments, etc. This may help prevent misinterpretation of statements.

An effort at one time was made to keep meetings of the New York Society of Security Analysts "off the record." However, there were so many slips and annoyances as a result that all speakers are told that anything they say may be quoted. Even if the press is not present, the far-flung wire system of some of the large brokerage houses is so great that a quotation transmitted over those wire systems may get to many financial people just as readily as a quotation in the press. Therefore, in large meetings a company would be unwise to assume that it can be "off the record." Sometimes the press does attend, and it is well to have a press release available. This should be handed out with copies of the talk. If no copy of the talk is made but a press release is available, there should be sufficient copies for all those present.

Standing exhibits around the room may be effective and add a sparkle to the meeting. This all depends on whether they tie in with the factors affecting the company's securities.

Some companies provide a door prize of one of the company's products. If this is to be done, the product should definitely be tied in with the company in some way. It should, under no circumstances, be used merely to win good will, or be so elaborate as to give an impression of trying to influence the analysts. It will only backfire. Unless a company is careful, this is a practice which should be frowned upon.

We have referred to New York City as the principal financial center. It is that. However, there are many other important financial communities, and in a complete investor relations program other cities should be included, if investors in those communities are interested in the company's securities. It is quite possible, if a company does not have a national following, that the financial center nearest its office may be more important than New York City.

### *Written Material*

*Annual reports*—First on the list of written material, of course, is the annual report. Some companies design their annual report primarily for the security analysts and use it as the principal written medium to get across their story to them. There are very few annual reports which are written without being partly directed at the security analysts. A well designed annual report can serve both types of investors.

Writing annual reports is not an easy task. By the time all the "brass" has approved it, the unfortunate person in charge of the report is about ready to jump out a window. The real audience has been lost sight of, the lawyers have cut out much interesting material, and fears have been expressed by someone in top management about practically every word.

One reason why some annual reports seem to fail is that they are not directed to a clearly defined audience. The report finally becomes a story by the management, which makes very good reading for them and the directors, but for no one else. This failure may result from the fact that the person in charge of the report is not truly aware of the audience to whom the report should be directed. If he has selected an audience, he should make it known to those who contribute to and have the final say on the report.

Obviously, many groups have to be kept in mind in writing a report. Material should not be included which will harm employee or union relations, because some of the reports are bound to get into their hands. Nothing should be included which will adversely affect customer relations, or public relations. Nevertheless, if an effort is made to write an annual report for use by directors, uninformed stockholders, informed stockholders, the employees, consumers, etc., the report is bound to fail.

In some companies, the public relations expert is allowed to usurp the job of writing the annual report away from the Financial Vice President. Unless he is an expert in finance, he may be so carried away with general public relations ideas as to miss the audience to which the report should be intended. Of course, the public relations expert should be consulted to make certain that the report does not include anything at cross purposes with a public relations program and, at its best, he should work as part of the team. The important point is that whoever works on the report should have as his goal the problem of achieving communication of the financial story, and not just of producing a report that looks well.

With regard to annual reports, analysts differ widely as to what they desire in general design. Some want no pictures and charts, whereas some want a lot. It seems best to reach a balance. Include pictures or charts only if they add to the story. Mere glamorization for its own sake is not impressive to the analysts. Charts should be so designed that the analysts can read off the figures if they wish to use them in a story. For example, bar charts are very effective when the figures are also shown within the bars. But be sure to make the report easy to read and interesting, because a company is competing for an analyst's time. During the report season, the financial community literally rains annual reports. Size of the report would seem to be unimportant, but this is not so. Analysts prefer the regular letter size of 8½ by 11, approximately. It is much easier to file than one of odd size.

In designing your annual report, don't try too hard for variety each year and thus hurt the effectiveness of the report. The form of the report may seem monotonous to you, but not to the audience which receives it once a year.

An annual report must have three attributes to be good:

1. It must present all the facts, both favorable and unfavorable, about a company's operations during the year and immediately contemplated which may have a significant effect on the value of its securities. Regardless of the other qualities of a report, the omission of any such fact will seriously damage its value. This may be termed *completeness.*
2. The material must be presented in such a way that it can be used readily in evaluating the securities. As a simple example, a wage increase must include the annual amount and also the date it became effective. This may be termed *analytical quality*.
3. Finally, the material must be presented in an interesting way and it must be easy to read. This may be termed *readability* in its broadest sense.

In the Industrial Financial Seminar, which I conduct for financial executives, there is a session on annual reports. Four top financial analysts[3] criticize the annual reports of those companies which are represented at this lively meeting. These analysts have had long experience in the field and have read hundreds and hundreds of annual reports. They have served on annual report award committees. The session is started off by one of the analysts, Joe Galanis, presenting a brief summary of a memorandum he was once requested to prepare on "What Constitutes Adequate Corpo-

[3] J. M. Galanis, Winslow, Cohu & Stetson; George F. H. Nelson, U.S. Steel and Carnegie Pension Fund; Edward R. Holt, Newburger Loeb and Company; Edward S. Wilson, W. E. Burnet & Co.

rate Information from a Security Analysts' Viewpoint?" Excerpts from it are included below. The material requested may be more than your company would wish to give out. You might prefer to reserve it for a statistical book rather than an annual report. Don't interrupt your train of thought to go over it carefully at this point. Take a quick glance at it now and refer back to it when the occasion warrants. When you do read it, have in mind that it is a general inventory of all types of information that might be desired of industrial companies, only part of which may fit your company. Also, from looking at this mass of information, don't get the idea that it is figures alone which determine an analyst's opinion. There are many intangibles, such as the quality of research, the depth of management and its enthusiasm, etc.

The analysis of an industrial common stock, basically, is the analysis of a particular business enterprise. Thus, the trained security analysts devoted to appraising industrial common stocks can be presumed already to possess a fairly broad and fundamental knowledge and background in many important industries—autos, steels, chemicals, paper, goods, machinery, merchandising, etc. To undertake a worthwhile job of a comparative analysis of any individual issue he will, at the very least, need to have made available on a continuing basis information from the corporation or corporations being examined of the following type:

1. Sales:
   a. In dollars and physical units (tonnage, barrels, yards, pounds, etc.).
   b. The major product groups in dollars, physical units, or both.
   c. In dollar volume by major consuming markets.

   This kind of information permits comparison of an individual company's progress against the industry's background, figures for which are usually available. It also will reveal what markets are served by the company—and normally, a great deal of industry data is made constantly available through trade papers, trade associations, financial newspapers and publications, government bureaus, etc.
2. The following major expense items should be detailed:
   a. Wages
   b. Material costs
   c. Selling, general and administrative expense
   d. Depreciation, depletion, and amortization
   e. Cost of goods sold
   f. Profit from operations, excluding non-operating income
   g. Non-recurring items
   h. Federal income taxes
3. Other important information desired by security analysts is:
   a. Number and location of plants and total capacity in physical units. A good map is well worthwhile.
   b. Number of employees—either at the year's end or the average for the year.
4. Sufficient detail with respect to the extent of integration, control of raw material supply sources, etc.
5. Percentage of total dollar sales volume representing defense shipments.
6. Unfilled order backlogs *vs.* year-earlier totals.
7. Details on foreign business covering sales, earnings, dividends and undistributed profits. Location of foreign sources of business by countries and the above breakdowns by countries. It does not matter from the analysts' viewpoint whether you consolidate your foreign operations or not, as long as you give all the pertinent information.
8. Annual amounts spent for research, together with other details of research activities; discussion of new products; percentage of most recent year's sales volume representing new products developed by the company over the past, say, 10-15 years.
9. Major raw materials used in the business and sources of supply.
10. Methods of distribution employed.
11. Industrial or banking backgrounds of non-officer members of the Board of Directors.
12. Information respecting management training programs.
13. Explanation of hidden assets, *i.e.*, such as timberlands under-valued on the books, or investments in affiliates or subsidiaries carried at values well below prevailing appraisal or sale values.
14. Capital outlays for the most recent year,

and contemplated for at least the next year. Discussion of expansion plans and programs; also, methods for financing them.

15. Comments on dividend philosophy or policy, in relation to indicated capital needs.
16. Significance of any patents and their expiration dates.
17. For extractive industries, estimates by competent persons of net proven reserves; also, production, new discoveries, and similar data.

Utilizing many of the above individual items of information provided by corporations, the analyst can proceed to calculate key ratios, such as margins of profit before taxes, over a period of years. This, in turn, permits the revealing of trends within a given company. By comparing these various key ratios with similar ratios of other companies in the same general industry, it is possible to garner some ideas as to whether the individual company examined is going ahead of the industry, falling behind or standing still. This approach also pretty clearly reveals the low cost, high cost or middle cost operators in a particular industry.

By working out index figures on sales, operating income, net income, earnings, dividends per share and price movements of the common stock, over a period of, say, 10 or more years, the progress or lack of progress by an individual enterprise can be ascertained.

Pressure of time, especially in the early months of the year when a flood of annual reports is released, frequently permits no more than a cursory glance at numerous important annual reports. Therefore, it is vital to offer a good "highlights" summary, a brief President's letter, and an index, at the very beginning of the report. The narrative throughout the report should be divided by headings and should be concise, explaining what happened and the reasons therefor, together with prospects for the new year as visualized by management. Regular income and balance sheet accounts should be on a two-year comparative basis. Ten-year condensed income, balance sheet and operating data tables are also highly welcome and, for modern corporate reports, have become virtually standard procedure. These 10-year tables are particularly useful in tracing trends.

Charts, pictures, statistical tables, etc., are all interesting and helpful additions to the analyst in his efforts to obtain a clearer picture of a company's position, prospects and its ranking in its particular field or fields of endeavor.

The date and place of the annual meeting should be included.

*Statistical book*—Some companies, especially those in regulated industries which have to file considerable amounts of statistical information with public agencies, use a combination of the annual report and a statistical book for the security analysts. It may be difficult for some of these companies to satisfy analysts completely with an annual report. There may be so much extra statistical information of interest to them, that it cannot all be presented in the annual report. However, don't compile a statistical report unless there is some worthwhile information which can be of real use.

What a company includes in the annual report will depend to some extent on whether or not it plans to issue a statistical booklet for the analysts. A relatively uncomplex annual report, containing the essential information which would go out to all the stockholders and a detailed statistical book for the analysts, would appear to be the ideal combination. The analysts, however, do not like to have a company cut down the annual report to a bare skeleton, even if the statistical booklet is issued. If a statistical book is issued simultaneously with an annual report and reference is made to the statistical book in the report, then the annual report can be reduced in size and the excluded material put in the statistical book.

The purpose of a statistical book is more than just a supplement to the annual report. It may be used to gather together a large quantity of information for the analysts which originally appeared in many different sources. It may be used by some companies to present explanatory information about operations and finances which cannot be included in the annual report. For example, in the operations of a company in the food products business, the hedging of wheat plays an important part and has an effect on the income statement and balance sheet. It is somewhat complicated, but most important to a thorough understanding of the company's finances. A section on this subject in a statistical book was very effectively employed to elucidate and educate the analysts.

Analysts vary in their preferences for design of a good statistical book. A combination of good charts, tables and explanatory material seem to fit the needs of the majority. Pictures generally need not be included unless they contribute to the analysts' understanding in some special way—perhaps, in areas of new technology, for example, pictures of the company's products or its various plants may help greatly.

A statistical book with tables alone just does not do the job it is supposed to accomplish. An explanation of the important factors affecting the company's operation is necessary. Elaborate footnotes are well worthwhile, but be sure to have them in large print. If they are used, then make them readable.

It is an important decision whether or not to issue a statistical booklet concurrently with the annual report and, in effect, make it a supplement for the analysts. There is another choice, and that is to issue the statistical booklet every two years or as the occasion seems to necessitate it. Do not decide to issue a statistical book until you have arrived at a definite decision on this point. It will influence what you will include in it.

In a statistical booklet, the question often arises of whether a company should figure out the financial ratios, or leave them for the analysts to calculate. Some of the ratios, which are of a standard nature and figured the same by all analysts, such as earnings per share on total shares outstanding, should be included. There are many ratios which analysts have their own pet way of calculating. If you choose to figure those ratios, there should be included a detailed footnote stating how you did them, so that the analysts can see if it is in agreement with their own method. In your development of ratios, you would do well to discuss them with about five analysts so that you will be sure of the ones to include and how to present them.

*Quarterly reports*—Annual reports become obsolete a few months after they are issued. Earnings and balance sheet items change and new developments arise regarding the company's operations. Interim reports are the ideal way to keep the investors up-to-date. Quarterly seems to be the best time interval for issuing such interim reports. Analysts are quite outspoken about their need of such reports.

Some types of companies have brought the quarterly report to perfection. Many electric utility companies issue quarterly reports including: an explanatory statement as to what has happened since the last report, three-months and twelve-months comparative statements, and a balance sheet. Electric companies, of course, are well suited to issuing such reports, because they don't have an inventory problem and their sales are relatively steady. However, in some industries, the battle between companies and the analysts, regarding interim figures, has been extremely vociferous. Some companies contend that it is necessary to take a complete inventory in order to present interim figures that are not misleading. Nothing would be gained here to argue the pros and cons of that battle. Let it suffice to say that if a company wishes to do a good investor relations job, it must appreciate the importance of interim reports. It should attempt to comply, insofar as possible, within moderate cost. Don't be afraid of reasonable estimates of inventories, etc., and don't make an issue out of interim reports if you can furnish them. At least, include as much information as possible. If you can't furnish what analysts want in a quarterly report, then accept it as one of your problems to explain why. Don't think you can fool them; they are too close to too many companies, and know too much about financial statements.

*Other written material*—There are many other written media, such as prospectuses, general press releases, company house organs, court or government agency decisions, special reports, etc. All written material should be weighted as to the part it will play in keeping the analysts currently informed about all the company's operations. For example, a prospectus issued in connection with a new security offering should not be viewed as a legal requirement, but as an opportunity for a company to tell a real story, unless investors are already well informed through a recent annual report and statistical book.

Above all, don't burden analysts with written material which is not pertinent. They are deluged with reading material. The importance of laying out a program comes in right here. Planning will make it possible to see just what is required to do an effective investor relations job.

Don't overlook material published by others about your company, such as that by the three agencies, Fitch, Moody's and Standard and Poor's. The importance of the manuals for annual figures, etc., is covered in Chapter VI. In their regular current services they carry interim reports and other pertinent data.

Analytical material and opinions about a company are also furnished to investors in reports or studies made by security analysts in various types of financial firms. Often companies are asked to review these reports before they are sent out. A company should welcome this review as a real opportunity, since the reports may be given wide distribution. This can also prevent publication of material which may be erroneous. However, in reviewing the reports, make it clear that you are passing on the facts and not the opinions of the analyst who may cover forecast earnings.

*The financial press*—The financial press represents an excellent medium through which to disseminate information to investors. The approach is somewhat different from that used with the analysts. Very probably, a company will have someone handling press relations, and if there is such an expert, the financial officer may best work through him. The following comments are made with this in mind.

You cannot tell the press what, when and how to publish information. Editors publish what they wish, when they have space. But if you ignore them or fail to do your part with the press, you may not receive as much coverage as you would like and some stories may be published which will not do justice to your operations. Treating the press fairly and keeping it informed produce the best results. A company representative should get to know the financial editors and their staffs personally, and get to know what, when and how they want material about his company.

The type of material will depend on the nature of your company. The test is whether it has a broad interest to the people who read the financial pages—or, occasionally, an interest even to the public at large. Earnings reports are a regular item. They should be comparative. Annual reports should be sent in with a press release. Changes in management get some play. Other items might include expansion programs, financing, new ideas on the science of management and advanced planning, new technology, etc. A speech made at an analysts' society is well worth sending in with a press release.

In sending in material to the large metropolitan newspapers, one copy should be sent to the financial editor. You should know who specializes in your type of company and also send him a copy. On each copy, mark the names of others on the same newspaper to whom you have also sent copies. When you are going to make a speech, send in a copy so that it arrives at the newspaper one day ahead of time. The time and day for release should be conspicuously marked on the release. For Sunday papers, the material should be in the hands of the press at least by Thursday evening. Except by pure mistake, the release date will be carefully respected. Some company officials are so afraid that a speech will appear in the press before it is given that they won't send in a copy until afterwards. If this is done, the papers can't print it until a day or so later and then it has lost its news value. When you do send in a speech or other material, indicate where you can be readily reached in case there are any questions, and how the newspaper can verify that the speech was delivered.

In building your personal relationship with the press, you should see that its members are invited to major meetings, such as stockholder meetings. Have in mind what was said above about working through your press representative. When something important happens which the financial press considers newsworthy, one of the top men in your company should be available and willing to talk. The press should know who your spokesmen are and where they can be reached. If a large, unusual piece of financing has been announced and the press calls and cannot find anyone who will discuss the matter, the ill will resulting may not be overcome for a long time. Furthermore, the reporters will have to write a story based on inadequate information. It may hurt your company.

Whether or not your story will be printed will depend on its newsworthiness and also on the space available in the paper. It will also depend on how it has been handled and on the timing. Even if you have done a perfect job of presenting it to the press, there is terrific competition for the limited space available. Each paper has a limited number of pages in which to cram an almost limitless amount of possible copy. The editor has to use his best judgment under pressure and in a great hurry.

In addition to the newspapers, the wire services are very important—the Associated Press, United Press International, and Dow-Jones and Company Ticket Reports. They should be at the top of your list. Magazines should not be overlooked. Getting attention by magazines is a much longer process and must be treated on an individual basis. In most instances, they prepare a long study rather than use spot news.

The press does not particularly care whether you handle your own press relations, or use an agent. If someone in your company has the time and can learn the proper way to handle it, you may get better coverage. There is always the personal relationship that can be developed and, also, agents have to spread their efforts over a large number of companies.

*Financial advertising*—Financial advertising may have a limited place in a company's program. The message should fit your particular need in communication with investors. If you are trying to reach the financial analysts, find out the few media they read in your field and design an advertisement which will catch their eye. They are unimpressed by run-of-the-mill material about dividend notices, etc. Don't waste your money on an advertisement unless you can give it sufficient attention.

### *Problems Encountered*

Investor relations is not always a smooth road. Numerous problems are sure to develop. For example, a company cannot proceed very long without having to decide what to say about forecast earnings and dividends. We have already discussed handling forecast dividends (Ch. III), and the same idea applies to earnings. In the first place, it should be thoroughly understood that it is a very natural question for analysts to ask. The value of a common stock is dependent on future earnings and dividends. If the company does not make its own estimates, an analyst must make them for himself. There is a great divergence of opinion among analysts as to whether a company should give out forecasts. Some are very insistent and will condemn the management for not doing so. Others will ask but not persist. If a company is in a relatively stable business, so that it can be sure of its forecasts, it may decide to give them out. Many electric companies do this. It is a danger for a company in a relatively volatile business to issue forecast earnings and dividends. No matter how much the forecasts are hedged and said to depend on many factors, some analysts may use them to get their customers to buy the stock without explaining the hedges. If the forecasts don't turn out to be right, the analysts will forget the hedges and blame the company. As you can see, this can develop ill will.

If a company is not sure of the outcome, it is better off in not giving out forecasts. Yet, a company should be sympathetic to analysts' requests and handle them diplomatically. It should not give the impression that the analysts are being unreasonable. Furthermore, it should not hesitate to give out information which will help the analysts form their own judgment. There is a vast difference. In many cases, even the analyst who most persistently seeks earnings forecast can be satisfied if you will discuss with him, realistically and in some detail, the factors which may affect earnings in the coming year, so that he will be able to make a reasonable forecast for himself. For example, analysts are interested in future construction programs and future financing. A company should not hesitate to give out such information just because its program may change. Analysts fully understand that in a dynamic society a company may have to change its plans. It is only that ultimate figure of forecast earnings and dividends which may get a company in serious difficulty. It is with this that an analyst can blame his own mistake in recommending a stock directly on the company.

When an emergency arises which will have an important effect on your company, be prepared to handle it. The minute the news leaks out, it will have an effect on your securities. Investors, either directly or indirectly, will be calling analysts immediately, asking whether to buy or sell. It is not up to you to decide what they should do, but the analysts should be given all the information you have, so that they can form their own opinions. In such an emergency, the Financial Vice President should be prepared to handle phone calls personally. If a press release is prepared, it should be mailed to analysts. The event should be explained in detail in the next interim statement to security holders.

The importance of proper handling of emergencies would be fully realized if a Financial Vice President could be in a large financial community when such an event occurs. The phones start to ring. Investors call their brokers and investment advisors as soon as they have heard the news. Partners of firms call their analysts on the inter-office phone. The analysts call around among themselves and also call the company. Everybody is trying to guess and estimate the effect and trying to decide whether to buy or sell and at what price. If a company "clams up" at such a time, real ill will develops and everyone becomes overly suspicious. The Financial Vice President should be in charge of handling calls in order to prevent conflicting stories emanating from the company. That has happened, and produces the worst possible results. Of course, in some cases, there may not be a complete answer readily available. Then the company may find it desirable to postpone giving out any answer until the full story is available; for half an answer may not represent the company fairly. In such a case, as soon as the full story can be told, it should be communicated as broadly as possible.

What does a company do when its earnings are on the decline or it is facing a number of problems? Does it then ignore the financial community? Absolutely not. And this is where a soundly conceived investor relations program comes into play. If a company handles its investor relations on the basis of a regular, well-planned program, it will never have to face the problem of doing a job when things are bright and then crawling into its shell when things look bad. A regular program will not be as glamorous as making an appearance just when the company has an optimistic report or there is some unusual development to explain. Nevertheless, it is the only way that proper results can be achieved over the long run. It helps avoid the very unfavorable impression and ill will which result from withdrawal during adverse circumstances. That is why so much stress was placed in the first part of this chapter on managements' understanding the true purpose of an investor relations program.

No matter how perfectly a company handles an investor relations program, a few analysts will be dissatisfied. There are unreasonable analysts, just as there are unreasonable people in every group. Don't antagonize them: they will probably talk against your company in the financial community, building ill will for you. Do the best you can, diplomatically, and you will be successful in your program. If you do a good job with the high grade analysts, and especially with those analysts who most regularly follow your company and thus become experts in it, you will find that your image will be such in the financial community that those who make unreasonable comments will not usually affect your reputation.

The unreasonable analysts include those who want inside information for themselves exclusively. If an analyst has written a fine story about a company and that company has helped the analyst with some figures, there is no need for management to feel it should immediately broadcast the information to all analysts. An analyst who ferrets out information has a right to it. However, the company should be willing to treat all analysts the same and give information and assistance freely to all. Don't play favorites. Of course, it should be recognized, in this connection, that even if all analysts are satisfied with the company's investor relations' program, there still will be some who, with justifiable reasons, will wish to sell your stock. This should be recognized as a natural process of investment.

A few analysts seem to feel that a company should withhold information which it may have given out to a small group, until that group has had time to take advantage of it and buy securities before the information is distributed generally. In fact, analysts have been heard to complain because some companies have issued press releases after meetings with analysts. No analyst has a right to object to such a policy and the company would be most foolish to yield to such pressure. Everything should be open and aboveboard.

Sometimes rumors start around Wall Street to the effect that the analyst in an investment banking firm may get forecast earnings and dividends because one of the partners of the firm is a director of the company—an unfair practice. It is one of the disadvantages of having directors of investment banking and other types of financial firms on a board and should be guarded against meticulously. It is a form of favoritism.

As previously mentioned, some special considerations arise when a company is going to sell new securities, since it will have to comply with the Securities Act of 1933. A company should check with its lawyers to make certain that there is no legal conflict if a meeting is scheduled with analysts, or if written material is issued at that time. Some lawyers will overemphasize caution to a point that a company may eliminate all of the investor relations program for a period before and after the offering. Such a procedure is unnecessary. No company which has been doing a conscientious job of keeping investors informed will be accused of violating the provisions of the Act. However, because the problem exists, the new financing schedule should be included among the items to consider in designing an investor relations program.

## CONCLUSION

Much stress has been laid on detail in this chapter. It is very important. By lack of careful attention, an investor relations program can be ruined. Analysts are a critical bunch, and they see how many companies perform. Little slips become only too obvious to them. If you want a quick review, look over the summary outline which follows.

## SUMMARY OUTLINE—INVESTOR RELATIONS

PRINCIPLE: The purpose of an investor relations program should be to communicate effectively and promptly all information having any effect on a company's securities, whether good or bad, so that those who evaluate securities will have complete information on which to base their judgment.

### *Advantages*

Management has an obligation to keep investors informed. Fortunately, there are real advantages to an investor relations program:

1. It helps assure a fair market price for the company's securities. Over the long run,

a sound investor relations program should raise the price level of the securities and also help reduce the fluctuations in the prices.

2. It facilitates raising new capital.
3. It assists in obtaining support for management's policies.

### *Approach*

Above all, the approach must be properly conceived. Security prices are fundamentally determined by the relative risk factor. By having complete knowledge of a company's operations, investors can better understand the risks, while lack of information adds an element of risk. The attitude should be to present and explain all the facts, both favorable and unfavorable, so that investors will have a better understanding of the company. It should not be to give the securities an artificial build-up.

There is quite a distinction between reducing the risk through complete information and temporarily bullying your stock by giving out only favorable results. The latter, in the long run, will be disastrous and lower the price of your stock.

### *Program*

Outline a program for, say, two years in advance, to avoid duplication of efforts, and assure coverage. It should be tailor-made to fit the needs of the individual company.

Distinguish between Informed and Uninformed investors. Build a good list of the former group.

Determine methods of contacting each group and information each needs.

Don't try to guess what the informed investors want to know about your company; ask them.

### *Media to use*

Personal Contacts:

Personal calls, stockholders meetings, analysts' society meetings, luncheons, receptions, Due Diligence meetings, trips, etc.

Written Material:

Annual reports, statistical books, post-annual meeting reports, interim reports, press releases, etc.

CHAPTER X

# Profit Goal—Cost-of-Capital

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## YOU MUST HAVE SOME GOAL

In our type of economic system of private capital, management has to make the decisions regarding the investment of capital for expansion of existing lines or for new projects. Management directs the flow of capital into this or that project.[1]

In directing capital expenditures, management must make certain that there is a sound indication that all costs, such as for labor and raw materials, will be paid, and that capital will be adequately compensated. If the latter is not accomplished, then the investors who have put up the money are adversely affected, much as employees would be hurt if the company went bankrupt and could not pay satisfactory wages. Furthermore, misdirected capital may cause overproduction with ensuing adverse effects on our economy. The result is a waste of capital.

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[1] In the utility industry, management may be forced to expand by regulation in order to provide service under some circumstances, even if the prospects for profits are inadequate. This, of course, is unfair to investors.

Whenever a company decides to build a new plant, it cannot avoid the question of what is meant by adequate compensation for the capital. Whatever a company's standard, it, ipso facto, must have *some* standard.

What should be the basis for the proper goal? The start towards the answer, as we said in Chapter I, is what investors require, in the sense of anticipate, as a return under average conditions to induce them to provide the capital, in a competitive capital market. This is termed Cost-of-Capital. If a company does not earn a correctly interpreted and determined Cost-of-Capital, it has failed in its management of capital, whatever the reason may be. This is a bare minimum. To be successful, a company must earn more than the Cost-of-Capital, and all further capital investment, direct or indirect, should hold out a reasonable prospect of earning more than bare Cost-of-Capital.

If a company is privately owned, it is just as important that it have a proper goal for new projects. It should not earn less than could be earned if the same amount of money were invested in the competitive capital market under the same circumstances.

Much of this chapter will be devoted to explaining how to establish the goal; towards the end, it will be explained how to apply the goal.

## CONFUSION

Confusion seems to exist as to what is meant by Cost-of-Capital, and what is a proper goal. For example, when the question was raised at a management conference[2] of a group of financial officers of industrial companies, some of the replies were:

"My company just sold $30,000,000 of bonds at an interest rate of 4%. The money will be used for a new plant. Therefore, the capital cost will be 4%. Anything over 4% will be a profit."

"No," said another, "you also have to consider as a cost the dividend rate you pay on your common stock."

Still another suggested: "My company has earned 15% on net investment over a long period of time before income taxes. We use that as a 'bench mark' when we go into a new project."

One even switched to percent profit on sales as the goal.

This one was avoiding the problem completely. Percent profit on sales may be a very valuable management tool and an important factor to consider in deciding on capital expenditures in certain industries. However, it is far afield from the final test. Percentage on sales alone ignores the amount of capital required to produce those sales. Capital is the item on which the return must be earned.

Of course, all of the answers were wrong. Why so many incorrect answers? Probably there were many reasons. First, it was not known clearly what Cost-of-Capital means. Moreover, in recent years industrial companies have obtained most of their equity capital requirements through retained earnings rather than through sale of stock. Hence, they have had little contact with an important source of information on Cost-of-Capital.

Another reason for so many incorrect answers is the complexity of the problem. It requires a knowledge of finance and economics —hence, the necessity for this chapter coming at the end. Long-term capital may be obtained through the sale of securities such as bonds, preferred stock or common stock; or from retained earnings. A decision must first be made about the proportions of each of these media. Next must be determined the cost rate to raise capital through each type of security included in the capital structure. This requires a knowledge of financial markets over a reasonably long period of time, and of such related matters as financing expenses, etc. Perhaps more important, it presupposes a knowledge of the reasoning investors apply when they invest their money.

In any event, everyone at this meeting did agree on two points: Cost-of-Capital is particularly important; and it is not a simple problem.

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[2] Seminar conducted by the American Management Association, "Establishing the Criteria of Good Financial Management."

## RELATIONSHIP TO RETURN-ON-INVESTMENT

A concept that is sometimes confused with Cost-of-Capital is Return-on-Investment, referred to as ROI. It is related but it is entirely different. Return-on-Investment is an important management tool for industrial companies, principally for measuring performance of the various product or operating divisions of a company.

ROI is the percentage relationship obtained by dividing earnings after expenses by the assets utilized in producing those earnings. On new projects, the ROI is an estimated percentage. While, for some purposes, ROI can be used independently of Cost-of-Capital, there should be an understanding of the relationship of the two concepts for a full utilization of ROI. ROI will not tell us how much should be earned in order for profits to be satisfactory. Cost-of-Capital must answer that question.

There are many formula approaches used by industrial companies to evaluate management performance and as tools to assist in determining whether to go into new projects. They all involve the necessity of first deciding upon a goal. For example, some industrial companies use the Discounted Cash Flow Method, to be explained subsequently, for determining the rate that will be earned on a new project. When asked how the formula is applied, you may be given an answer such as: "We figure out the return on new projects by the Discounted Cash Flow Method. We always have many projects on the fire and we take the most profitable ones."[8] Another answer might be: "We go into all projects above a certain arbitrary figure." These statements, of course, duck the real issue of deciding on a goal. In the first statement, there is no goal whatsoever; in the second statement, the goal is arbitrary. What we are going to work on in the first part of this chapter is the goal or standard itself.

Because the formulas are constructed on different bases, great care will have to be used in applying the goal to the formulas. For example, Cost-of-Capital first involves reference to the liability side of the balance sheet, whereas ROI is generally calculated with assets as the denominator. To tie in the use of Cost-of-Capital with ROI, it is necessary, in making the transition from one side to the other, that an allowance be made for any difference in the methods of calculating the two concepts. The same idea applies in the application to the Discounted Cash Flow method. This problem will be discussed after we explain Cost-of-Capital.

## A PRINCIPLE—COST-OF-CAPITAL

Let us put the broad meaning of Cost-of-Capital into a few words. As we proceed, their significance will become apparent.

1. Cost-of-Capital is the over-all composite net cost rate to the company, after allowing for underwriters' compensation and expenses of financing, of what investors require to induce them to provide all forms of long-term capital, in a competitive capital market.
2. It is the minimum goal for the company as a whole. For an enterprise to be successful, it should earn above Cost-of-Capital.

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[8] If this approach is used, at least due allowance must be made for the quality as well as the size of the expected rate of profit. That is to say, that in selecting a project, the difference in risk should be evaluated along with the size of the rate of profit. For example, a project which is estimated will produce a 10% return after taxes may be more attractive than one which might produce 15%, because the risk in the project with the higher return is not sufficiently compensated for by the higher rate of profit. An example comes to mind in which a company executive was reluctant to expand the company's existing business because he found two other new projects which showed prospects of a higher return. Hindsight proved that the new projects in fact never would have produced any profit, while the existing business continued to provide a return commensurate with its risk. These thoughts should become more apparent as the subject of profit goals is discussed in this chapter.

3. For divisions of the company and new projects, the Cost-of-Capital will vary depending on the difference in the risk factors from that for the average for the company.

Note that it is a composite rate of all the capital. If a company sold bonds and used the proceeds to build a factory, the goal would still be a composite rate based on all the company's capital. It could not sell the bonds unless it had some common equity, which may have been provided some time ago by the sale of stock and gradually have been built up by retained earnings. No matter how provided, the rate on the common equity must be averaged in. Visualize the ridiculous situation which would arise if a company did use the rate on the type of security sold to raise money for a particular project. The goal would shift depending on whether it used debt or equity even for the same type of project. That would not make sense. This is not to be confused with the necessity of comparing the cost for one type of security with the cost rate for other similar types of securities, when deciding on how to finance. As we explained, for such a purpose, the rate on one type of debt security should be compared with the rate on other types of debt and not with equity or with a composite figure.

In order to obtain an understanding of Cost-of-Capital, we will first use as an example an electric utility operating company, and explain the technique as we go along.

## COST-OF-CAPITAL FOR AN ELECTRIC UTILITY COMPANY

While utilities are regulated as monopolies, the purpose of regulation is to allow earnings sufficient to attract and fairly compensate capital as though competition did exist. Therefore, the same principles apply as for an industrial company. An electric utility company is a good type of company to start with, for the following reasons:

1. Such companies generally use three types of securities—bonds, preferred stock and common stock. Thus, we can work with a cost for the three basic types of securities.
2. Utilities do not generate sufficient cash internally to provide funds for the large plant expansion which has been necessary. They have had to rely on the continual sales of securities, and there is much data available. The data is more comparable than for industrial companies, because there is less variation in risk and there is more uniformity among companies. Furthermore, there has been much study on the subject for utilities because they have to present testimony before regulatory authorities on fair rate of return.

### *Capital Structure*

To determine the Cost-of-Capital we must start with the capital structure. Let us finance an entirely new electric company with a total capital structure of $100,000,000. For illustrative purposes, our proportions of the three principal types of securities will be approximately the same as the composite figures for the electric industry:[4]

| | *Amount* | *Percentage* |
|---|---|---|
| Bonds | $ 50,000,000 | 50% |
| Preferred | 12,000,000 | 12% |
| Common Equity | 38,000,000 | 38% |
| | $100,000,000 | 100% |

First, a word about the amount at which each of the three components should be stated. We have covered this point for purposes of security analysis, but there are some different considerations for Cost-of-Capital. For security analysis purposes, bonds should be stated at the principal amount because that is the amount the company must pay at maturity. The company writes off over the life of the bonds either the premium above 100 or the discount below. Preferred stock should be stated at involuntary liquidating value, because that is the ultimate claim which the

[4] *Federal Power Commission, Thirty-ninth Annual Report,* Annual Report. 1959, Class A and B privately-owned electric utilities.

stock represents ahead of the common stock.

For complete accuracy in determining capital structure for Cost-of-Capital purposes, bonds and preferred stock should be stated at the total net amount the company received from the sale of each security. It is only the net amount received which provides capital and on which the company can make a return. As a practical matter, we are not interested in small differences in amounts. Therefore, there is no need to adjust balance sheet figures unless there is a major discrepancy.

The common equity for a going concern comprises the stated value of the common stock, the premium if any, the capital surplus and earned surplus. If a company withholds part of its earnings from the stockholders, it is actually obtaining new common stock capital. It is the same as selling new stock to the stockholders. The only difference is that, when earnings are retained, the stockholders have no choice whether or not to make the investment. Any earnings left in the company go into capital, just as though the owner put up new capital.

The company is expected to produce the same earnings on common equity, whether it be on the amount the stockholders provide through purchase of stock or on the amount of their withheld earnings. It may be suggested that, for earned surplus, no allowance need be made for financing costs, since none were incurred. However, a company should be in a position to pay out all its earnings in the form of dividends, if it so desires, and still earn enough to attract and fairly compensate capital. The company should not use as a reason for retaining earnings the fact that it does not have to pay financing costs on that part of its common equity. Such a procedure would be unsound financial policy. We will treat common equity as though all of it should earn the same rate.

If a capital structure includes convertibles, the cost rate for the common should be applied to that portion of the capital structure. As soon as they are converted, the convertibles will be common stock, and they will not be converted unless there are sufficient earnings to keep the market price of the common stock up above the conversion price. This assumes that the prospects are such that the convertibles will be converted. When they are issued, it would be expected that conversion would take place. These remarks in no way contradict what was said about convertibles as far as capital structure analysis is concerned—that they should be treated as debt until converted. Nor do they deny that, until converted, the rate is the actual rate on the issue concerned. But for Cost-of-Capital, we do have to view them as equity if conversion seems likely.

For an actual company, the capital structure should be used which best represents the company's financial policy. Use of one year may give a distorted picture. For example, if in one year a company sold bonds and in the next year it sold common stock, the capital structure ratios would jump up and down. Further, if a company has bonds outstanding with a heavy sinking fund, the debt ratio falls as the sinking fund is applied. And as earnings after dividends are plowed back, the common equity builds up. Cost-of-Capital purposes require an average capital structure over a period of years, representative of the financial policy which the company follows, as it would be viewed in the eyes of investors. If a company's capital structure, for some reason, is distorted, it may be necessary to reconstruct the company's figures. Whatever capital structure is used, care should be taken to apply cost rates to the components of the capital structure which are in keeping with the particular capital structure.

Now, let us turn to the cost rates to apply to bonds, preferred stock and common equity; but before we do so, there is an important question of what period to use which must first be settled.

### *Historical, Spot or Current Costs?*

There are three possible periods:

1. Historical cost, that is, the cost of each piece of financing, and the cost rate for the common equity which should be applied to the earned surplus as it was ac-

cumulated each year. This might be difficult to determine, but it would give a complete historical cost. A company obviously cannot totally disregard historical Cost-of-Capital from a financial point of view. If, for example, it has debt outstanding with an interest coupon of 4%, that interest rate must be paid. However, past financing, just like the cost of an old plant, is "over the dam" as far as use for determining pricing policy is concerned. It may be merely some evidence as to the average Cost-of-Capital.

2. "Spot" cost, or short-term cost, based on a month, a quarter, one year or even two years, obviously would not be satisfactory. As security prices go up and down, so might the Cost-of-Capital. "Spot" costs are primarily of importance with regard to financing at a particular time.
3. We are left with one other cost, current cost. From the principles of economics, you will recall that prices of goods are dependent on demand and supply, and that they tend to produce prices which will cover all costs—including the current Cost-of-Capital. By current is not meant "spot." We have already eliminated that possibility. By current is meant a period covering a sufficient number of recent years to give an average figure which would represent the cost to raise capital under varying conditions of good years and bad, bull stock market and bear market—in other words, a complete business cycle. What period to use is a matter of judgment. It would appear necessary to use at least five years in order to get away from "spot." A ten-year period might give more reasonably average results. Keep in mind that to the extent the period does not include a complete cycle, it may be biased on the high or low side.

We conclude that a company should regularly study its current Cost-of-Capital both on a five and ten-year basis, unless some other period is more appropriate. It should calculate its "spot" cost each year and use that figure to keep up to date its current cost studies, by dropping off one year and adding another as the years go by. Judgment should be applied in evaluating the weight to give to the results obtained from these periods, having in mind the factors mentioned above.

### *Cost Rates in General*

There are various approaches which can be used to determine the cost rates, the two principal ones being:

1. Net proceeds method—the net proceeds received for new issues;
2. Market prices adjusted method—the market prices of outstanding securities adjusted to approximate net proceeds.

We will explain how each can be used for debt and equity.

We must seek cost rates which will apply to the quality of securities in the capital structure. These may be obtained from the following sources:

1. Net proceeds method for new offerings by the company itself;
2. The market price adjusted method for a company's outstanding securities, if satisfactory market quotations are available;
3. Net proceeds method for issues of other companies of comparable quality;
4. Market price adjusted method for issues of other companies of comparable quality;
5. Market price adjusted method based on indexes of outstanding securities of comparable quality.

In special situations where comparable data are not available, it may be necessary to have a financial expert make a judgment estimate for the cost rates. If you should have to rely on this approach, be sure to explain that you do not want a "spot" figure.

For the first part of our discussion, we will be talking about the cost rates as they pertain to the rates that have to be paid to investors. This conforms to the way in which we just described the broad meaning of Cost-of-Capital. Subsequently, we will take account of the fact that interest affects a company's taxes.

### *Cost Rate for Bonds*

For our electric company, we will rely primarily on the net proceeds method for our bond cost rate. We wish to know the yield to maturity based on the interest coupon and the net proceeds the company receives when a new issue is sold. The net proceeds is the price the investors pay for the bonds less the underwriters' compensation and the expenses of financing, such as cost of printing the prospectus, legal fees, accountant fees, etc.

| *Company and Issue* | *Offering Date* | *Amount of Offering (000,000's omitted)* | *Price to Public* | *Underwriters' Compensation* | *Expenses of Financing* | *Net Proceeds Received by Company* | *Yield to Maturity Based on Net Proceeds* |
|---|---|---|---|---|---|---|---|
| Consolidated Edison 1st 51/4's of 1989 series Q | 12/2/59 | $75.0 | 101.52 | 0.74 | 0.82 | 99.96 | 5.25% |

The cost rate for the issue was 5.25%.

What is meant by the price of a bond was covered in Chapter VII, "Selling Senior Securities." The yield to maturity cost rate for bonds based on the net proceeds received by the company, is obtained from bond value tables. The tables spread the discount of the bond price below 100 or the premium above 100 over the life of the bonds on a compound interest basis. If the bonds have a serial maturity or a fixed sinking fund which retires a significant amount of the bonds prior to maturity, then a weighted average maturity should be used.

A well-situated electric operating company with a capital structure similar to our hypothetical one would probably have its bonds rated *Double A*. In order to obtain the cost rate for our bonds, we will refer to actual sales of bonds of electric companies rated *Double A*, of $10,000,000 principal amount or larger.

To illustrate how we get the cost rate, we will use the last *Double A* offering in 1959 by an electric utility company. The figures are shown below.

The other approach, the market prices adjusted method, is based on the yields of similar bonds already outstanding, and an adjustment is made in order to approximate the net proceeds figure. For example, Moody's composite average of yields on outstanding public utility bonds rated *Aa* was 4.71% in December, 1959. Thus, the cost rate on the *Aa* Consolidated Edison Company issue of 5.25% was 0.54% higher than the *Aa* Moody's bond average. The reasons for this spread and how its size varies have already been explained, but by way of review, the reasons are:

1. The market price for an outstanding issue is based on relatively few sales compared with the size of the issue. A new issue generally has to be sold at a discount in order to attract sufficient buyers to absorb the large supply of bonds.
2. Underwriters' compensation.
3. Expenses of financing.

Up to now we have only looked at "spot" cost. We will now calculate the Cost-of-Capital for a ten-year period. This period is used for illustrative purposes. Other periods may be more representative. Given below is the average yield to maturity, based on net proceeds to the company for each year, for all bonds of companies serving principally electricity of $10,000,000 principal amount or more rated *Aa* by Moody's that were sold publicly in the years 1950-1959. There is also shown the Moody's average of Yields for outstanding *Aa* utility bonds.

| | *New Issues Rated* Aa. *Yield Based on Net Proceeds*[1] | *Moody's* Aa *Average. Yield Based on Market Price of Outstanding Issues* |
|---|---|---|
| 1959 | 4.87% | 4.56% |
| 1958 | 4.17 | 3.92 |
| 1957 | 4.56 | 4.03 |
| 1956 | 3.85 | 3.43 |
| 1955 | 3.20 | 3.13 |
| 1954 | 3.10 | 3.00 |
| 1953 | 3.55 | 3.32 |
| 1952 | 3.20 | 3.05 |
| 1951 | 3.15 | 2.95 |
| 1950 | 2.74 | 2.68 |
| Average 1950-1959 | 3.64 | 3.41 |

[1] The yields are calculated to maturity after deducting the actual underwriters' compensation, and an estimated allowance for expenses. The latter were not readily available and the estimate is amply satisfactory for our purpose, since expenses represent such a small part of the cost for these issues.

The figures in the second column, as already explained, would have to be adjusted to obtain a net cost rate. For our cost rate for bonds, we will use the average result in the left hand column: 3.64%.

### *Cost Rate for Preferred*

Turning to the preferred stock, we can proceed in a similar way as for bonds, with one principal difference: preferred stock has no maturity. The only exception might exist if the preferred stock had a fixed sinking fund of sufficient amount to retire a substantial part of the issue within a reasonable period. In such a situation, we would have to consider the problem of maturity, but that is rather unusual.

For preferred stock, we wish to know the yield obtained by dividing the dividend rate per share by the net proceeds the company received per share when a new issue is sold. Again, the net proceeds is the price the investors pay less the underwriters' compensation and the expenses of financing.

| | *New Issues of Preferred by Companies Used in Bond Cost. Yield Based on Net Proceeds*[1] |
|---|---|
| 1959 | 5.29% |
| 1958 | 4.91 |
| 1957 | 5.25 |
| 1956 | 4.50 |
| 1955 | 4.20 |
| 1954 | 4.27 |
| 1953 | 4.50 |
| 1952 | 4.49 |
| 1951 | 4.60 |
| 1950 | 4.30 |
| Average 1950-1959 | 4.63 |

[1] The yields are calculated after deducting the actual underwriter's compensation, and an estimated allowance for expenses. The latter were not readily available and the estimate is amply satisfactory for our purpose, since expenses represent such a small part of the cost for these issues.

There is shown below the cost rate based on net proceeds for the last issue of preferred stock sold in 1959 by an electric utility company which had bonds rated Double A.

| | | | Per Share | | | | |
|---|---|---|---|---|---|---|---|
| *Company and Issue* | *Offering Date* | *Amount of Offering (000,000's omitted)* | *Price to Public* | *Underwriters' Compensation* | *Expense of Financing* | *Net Proceeds Received by Company* | *Yield Based on Net Proceeds* |
| New England Power Company 5.52% $100 par | 12/10/59 | $10.0 | $102.22 | $1.96 | $0.60 | $99.66 | 5.54% |

The cost of the issue was 5.54%.

Above is the average yield, based on the net proceeds to the company each year, for all preferred issues of companies included in the previous table which sold bonds.

If we were to compare these figures with yields on similar quality of preferred stocks already outstanding, we would find a lower yield on the outstanding stocks for reasons similar to those discussed under the cost rate for bonds. Usually, for preferreds, there is a greater spread between the yield of a new issue and one already outstanding of a similar quality.

For our cost rates for preferred, we will use the above average, 4.63%.

### *Cost Rate for Common Equity*

So far the problem has been a relatively simple one, but now we come to the cost of the $38,000,000 common equity and that is complex. We have to determine, as one component, what the company would receive per share for a new offering of common stock after deducting the underwriters' compensation and expenses of financing. For bonds and preferred stock, we had as our other component the *future* interest and *future* preferred dividend rate which the company had to pay in order to induce investors to purchase new issues. The word *future* is italicized to focus attention on the fact that the cost to the company and return to the investors are determined by looking ahead and not backwards.

But what is our other component for common stock? This is where the difficulty starts. The company has no legal obligation to pay anything or earn anything on the common stock, as it has on bonds and preferred stock. How, then, can there be a cost for common stock? Terminology causes this confusion. True, a company does not have a legal obligation to pay or even earn on its common stock, but certainly no investor would buy common stock unless he could expect to receive a return. The company must show prospects of earnings in the future in order to attract common stock investors. Common stock earnings are not a cost in a strict legal sense, because they are not contractual obligations, but they are most definitely a requirement of attracting common stock capital. They are a true cost in an economic sense.

Perhaps there is some question as to what is the measure of the cost. Is it the earnings on the common stock or the dividends paid, or something else? Look at it from the investor's point of view. The amount of earnings paid out in dividends does provide the cash income to the stockholders, and dividends may affect the market price of a stock if it is publicly held; but so do many other factors. While investors do not receive in cash the earnings retained by the company above the dividends paid out, nevertheless they do own the earnings, since those earnings go into surplus. Furthermore, earnings have value because they will be used as capital to produce more earnings and, eventually, dividends. If you still think that it is dividends per share which are used for the cost rate on common, what about those stocks that do not pay any dividends although they have earnings? What *then*, no cost? Obviously not! In essence, it is the earnings which result in benefit to the stockholders and which ultimately determine the price of a stock. Thus, earnings per share is the other component of the cost rate for common equity.

If you need further help in understanding this idea, assume for a moment that a publicly-owned company with only common stock outstanding is transformed into a privately-owned company with one person holding all the stock. It is the prospective earnings that the owner evaluates in determining whether they will produce an adequate return on his investment. He can pay dividends to himself as he sees fit. Shifting our company back again to a publicly-owned company, it is still the earnings per share that is our other component of the cost rate for common equity.

An important point should be noticed concerning those earnings. Past earnings may be a clue to future earnings, but past earnings are "over the dam" when a stock is bought. It is the expected future earnings which investors evaluate when they buy a stock.[5] It is those earnings that determine stock prices and which make the price go up or down. Therefore, we may make the following statement as a principle for the cost rate on the common:

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[5] More comprehensively stated, what investors are willing to pay for a security represents their evaluation of the present worth of the flow of all possible future benefits. An earnings-price ratio to correctly reflect cost of common capital should allow for all possible future benefits.

> The cost rate for common equity is the earnings per share that investors expect will be earned in the future and which form the basis for making their investment, divided by the price per share which they as investors are willing to pay for new offerings, less underwriters' compensation and expenses of financing.

The term *expect* in the definition needs some very careful explanation. Here is one of the most difficult problems to cope with in determining Cost-of-Capital. If it is not understood and allowed for, the resulting Cost-of-Capital may be so erroneous that you would have been better off not to have bothered to figure it. Therefore, we will now try to explain how it is that *expected* earnings on common stock determine Cost-of-Capital.

Past earnings are a guide to future earnings to the extent that they may be repeated. Investors naturally study past earnings carefully to see if they afford a clue to what the future holds. In themselves, they produce a correct answer for Cost-of-Capital purposes only if the company is expected to earn in the future what it has in the past.

The importance of future earnings was well stated in an article[6] in the *Analysts' Journal*, as follows:

> Despite the uncertainties involved . . . it would appear essential for the investor to formulate some idea of future earnings, for this, in essence, is what he is buying . . . the present investment value . . . depends essentially on the future income to be expected from it. . . .
>
> Graham and Dodd, in "Security Analysis," suggest that an earnings projection be made covering expectations for a number of years in the future. . . .
>
> The SEC (Securities and Exchange Commission) has similarly emphasized that investment value must be based on earnings reasonably expectable over the indefinite future. . . .

The United States Supreme Court recognized the importance of future earnings in valuation in the following statement:[7]

> . . . There is the question of the method of valuation. . . .
>
> The criterion of earning capacity is the essential one. . . .
>
> Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earnings capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance. . . .

To apply the point, refer to the simple example given above, which shows, for three hypothetical companies, *A*, *B*, and *C*, the current market price for their stocks and the most recent earnings. There is also included hypothetical figures for earnings expected by investors. Earnings-price ratios are calculated on both earnings.

| Column | I<br>*Current Market Price*[1] *per Share* | II<br>*Most Recent Reported Annual Earnings per Share* | III<br>*Earnings-Price Ratio Based on Reported Earnings per Share* | IV<br>*Earnings per Share Expected by Investors* | V<br>*Earnings-Price Ratio Based on Expected Earnings per Share* |
|---|---|---|---|---|---|
| Company *A* | $100 | $10 | 10% | $10 | 10% |
| Company *B* | 100 | 5 | 5 | 10 | 10 |
| Company *C* | 100 | 15 | 15 | 10 | 10 |

[1] To save space, no allowance is made for underpricing to cover financing costs, etc. This omission will not detract from the purpose for which these figures are designed.

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[6] "Investment Value of Electrical Utility Common Stocks" by Charles Tatham Jr., *The Analysts' Journal*, Vol. 10: Number 5, November, 1954.

[7] Consolidated Rock Products Co. *v.* DuBois, 312 W.S. 525, 526.

In column III, the earnings-price ratios are 10%, 5% and 15% for companies *A*, *B*, and *C*, respectively, based on past earnings. Because each company is expected to earn $10 per share, the true earnings-price ratio in the minds of investors at the time they put up their money is 10% for each company, as shown in column V. Those companies must earn that rate to keep their stock selling at $100. We need this figure as a basis for the cost rate for the common.

It should now be obvious why it was previously stated that the relationship of most recent earnings to market price may produce such erroneous results under some circumstances that the estimated Cost-of-Capital would be worse than useless. Take another example of the case of a stock selling at 20 times earnings, the reciprocal of which is the earnings-price ratio of 5%.[8] With a 50% payout of earnings in dividends, the yield would only be 2.50%. It would be more than unlikely that a company could sell stock anywhere near a cost rate as low as 5%, based on prospective earnings. In fact, such a cost rate would be about as low as might be expected for the cost of a preferred stock. The reason for such a low earnings price ratio of 5% on the common would be that, in evaluating the stock, investors expect a future growth in earnings. As a further illustration, take the case of a company that has a loss in a year. If the company has any future prospects, the stock will have some market price. Yet, if we used the relationship of current earnings to market price, we would get a zero cost rate for the common. How ridiculous need we become in order to drive home the point: that it is the *expected* earnings which are required in order to determine the common cost rate.

This leads us to the following observations:

1. If a company's earnings have been relatively level and are expected to continue so, then the relationship of latest reported earnings per share to price per share can be used in determining the cost rate for the common. This might be typical of a company with no growth prospects.
2. If a company's earnings have been growing and are expected to continue to increase, latest reported earnings per share to price per share, will understate the cost rate for the common. Use of near-term prospective earnings will help to arrive at a correct conclusion, but there will still be a serious understatement if investors are including in the price they pay for the stock something for the long-term growth factor.
3. Conversely, if earnings have been decreasing and are expected to continue to decline, then the relationship of latest reported earnings per share to price per share will overstate the cost rate for the common. As with increasing earnings, the use of near-term, prospective earnings will help to arrive at a correct figure, but will overstate the cost if investors expect a steady decrease.
4. If earnings have fluctuated severely, then the relationship of latest reported earnings to price per share may alternately overstate and understate the cost rate for the common.
5. If a company has some assets which have substantial value and which at present are not being used to produce earnings, then the market price of the stock will include an estimate of the potential earning power or liquidating value of the assets. The reported earnings to market price would be of no value for Cost-of-Capital purposes unless allowance were made for the currently non-earning assets. Such a situation might exist for an oil or mining company with large reserves.

You will say, How can we ever solve this problem and find out what is in the minds of investors with regard to expected earnings? There is no simple answer. If you recognize the problem, you have correctly oriented your thinking. At least, you will be saved from arriving at meaningless conclusions.

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[8] To save space no allowance is made for underpricing to cover financing costs, etc. This omission will not detract from the purpose for which these figures are designed.

For a company which does not have level earnings, use of forecast earnings as obtained from investment services may help in arriving at estimates. It may be possible to study past figures and relate prices of the common stock to earnings which were reported in subsequent periods. Such a procedure, of course, assumes that investors were properly forecasting the earnings that actually materialized. No matter what method is used, the results will be only approximate. If your company has a continuous upward or downward trend in earnings, it may be necessary to refer to other types of companies, and other industries; then, by making allowance for the differences, to arrive at a broad figure. All of these difficulties in no way suggest that a company abandon the problem of determining an approximation of its Cost-of-Capital. It can and must be done.

| | | | | Per Share | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Company | Offering Date | Amount of Offering | Rate of Offering | Price to Public | Underwriters' Compensation | Expenses of Financing | Net Proceeds Received by Company | Estimated Expected Earnings | Ratio of Expected Earnings to Net Proceeds |

There is one factor, with regard to the use of the net proceeds method for common stock, that we have not mentioned. It concerns the number of shares to use in obtaining earnings per share, since the new issue adds to the number of shares. Generally, it is appropriate to use the number of shares outstanding just prior to the offering. This does not reflect the diluting effect per share of the new number of shares. If there seems to be an overstatement of earnings per share, remember that the new money should be invested to produce earnings on the new capital. Investors would expect this to be so. Some adjustment may be necessary if the new stock is offered through rights at such a low price as to include a partial stock dividend. There may be other special circumstances which will require some adjustment for the added shares.

Given here in tabulated form is the type of information you would need if you were to use the net proceeds method for the common cost rate.

The last column would give us the cost rate for the common.

No figures are included in the table, because we will switch to the market price adjusted method.[9] We will use for our data the figures contained in the Moody's Common Stock Average for 24 utilities. The quality of the stocks contained in this average is sufficiently equivalent to that of our company to serve for illustrative purposes. The figures for market price per share follow for the period 1950-1959. There is also included, in the middle column, the market prices adjusted for 10% [10]

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[9] Still another way to estimate the cost rate for common equity is through the dividend yield approach. This is seldom used because it is more indirect. It is most applicable to a company which has had a stable dividend record and for which it is possible to establish a proper dividend payout ratio. The steps required are: 1. Determine an average dividend yield, 2. Apply the payout ratio to obtain the earnings market price ratio, 3. Adjust the result for underpricing to obtain the equivalent common cost rate based on net proceeds. If applicable, allowance must be made for investors' anticipation of expected dividend increases, and for value of rights received by stockholders.

[10] Ten percent is a reasonable figure for underpricing for cost-of-capital purposes for a relatively stable type of common stock, like a utility company. For a more

for underpricing, to approximate the net proceeds the companies would receive for new offerings after allowing for financing costs, etc. It is these figures we will have to use to determine the common cost rate.

MOODY'S COMMON STOCK AVERAGE
24 Utilities[1]

| | *Market Price per Share* | *Market Price per Share Adjusted for 10% for Underpricing* | *Earnings per Share* |
|---|---|---|---|
| 1959 | $66.35 | $59.72 | $3.82 |
| 1958 | 57.96 | 52.16 | 3.63 |
| 1957 | 49.42 | 44.48 | 3.41 |
| 1956 | 49.62 | 44.66 | 3.35 |
| 1955 | 49.24 | 44.32 | 3.21 |
| 1954 | 44.30 | 39.87 | 2.94 |
| 1953 | 37.80 | 34.02 | 2.78 |
| 1952 | 35.48 | 31.93 | 2.62 |
| 1951 | 32.55 | 29.30 | 2.44 |
| 1950 | 31.23 | 28.11 | 2.62 |

[1]
Baltimore Gas & Elec. Co.
Boston Edison Co.
Carolina Power & Light Co.
Central Hudson Gas & Elec. Corp.
Central Maine Power Co.
Cincinnati Gas & Electric Co.
Cleveland Electric Illuminating Co.
Commonwealth Edison Co.
Connecticut Light & Power Co.
Consolidated Edison Co. (N.Y.), Inc.
Dayton Power & Light Co.
Delaware Power & Light Co.
Detroit Edison Co.
Florida Power Corp.
Houston Lighting & Power Co.
Idaho Power Co.
Indianapolis Power & Light Co.
Pacific Gas & Electric Co.
Pennsylvania Power & Light Co.
Philadelphia Electric Co.
Public Service Co. of Colorado
Southern California Edison Co.
Tampa Electric Co.
Utah Power & Light Co.

Now we face the difficult problem of trying to solve the riddle of what to do about the expected earnings that the investors may have had in mind in their evaluation of the prices of the stocks of these companies. Since this matter is so important, the Moody's Average figures are shown in chart form in order to provide a visual aid (page 326).

Except for one year, earnings per share showed a continuous upward trend, with an average annual increase at 4.8%. These companies paid out in dividends about 71% of the earnings for common stock; the balance they plowed back. A reasonable return on those plowed back earnings should be earned. Consequently, they should experience a gradual increase in earnings per share. Investors would have been correct in expecting an improvement in earnings and evaluating the market price of the stocks accordingly. A study of written material published by financial advisory services would reveal that such was the situation. As the steady upward trend persisted, there was an increasing tendency on the part of the investors to look farther and farther ahead in evaluating expected earnings. This may be indicated by the fact that the chart shows the market price to be increasing at a faster rate than the earnings.

If we divide the market price adjusted each year into the earnings per share, the average result for the 10-year period would be 7.7%. We know that this is far too low for a cost

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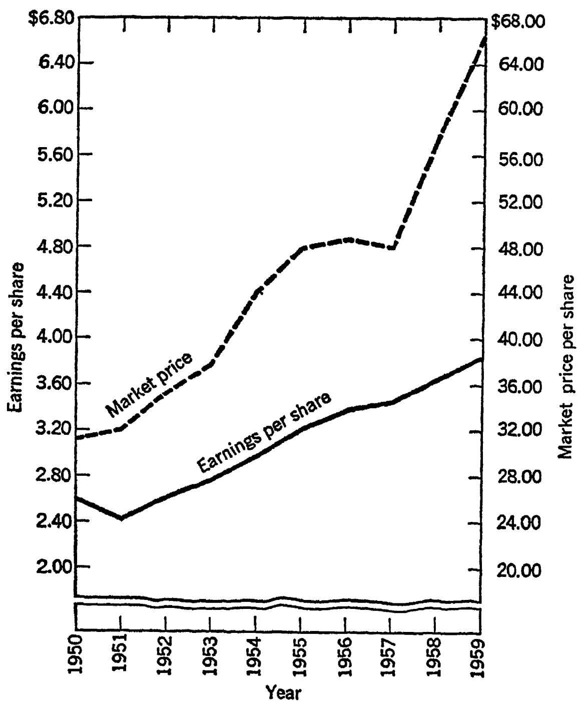
volatile type of common stock, such as an industrial, fifteen percent may be used. It may be contended that a somewhat lower figure could be justified on the basis of some figures on direct offerings of common stocks. However, a company should be in a position to offer stock through rights. Furthermore, in the discussion on rights offerings, it is pointed out that the stock of a company which uses rights should benefit in price from that method and thus compensate for any possible additional allowance for total underpricing.

rate for the common because it makes no allowance for the matter of expected earnings.



MOODY'S COMMON STOCK AVERAGE
24 Utilities

What do we do? We might suggest that in each year investors expected that, on the average, the upward trend in earnings would continue at least for one year. On this assumption, we would divide the market price adjusted in one year into the earnings per share in the next year. This would give us an average cost rate for the common for the 10-year period of 8.2%. If we divide the market price adjusted in one year into the earnings per share two years ahead, we would obtain an average cost rate of 8.8%. This approach may compensate sufficiently for anticipation of future earnings growth by investors in the first few years of the period we have used, but certainly not in subsequent years. Investors, as stated above, were looking farther and farther ahead. For example, at the end of 1959, it appeared that investors were so confident of the continued upward trend that they were looking as far as three years ahead, and possibly even five or ten years ahead, having in mind the continued growth factor.

These comments on investors' appraisal of expected earnings are made on the basis of the author's knowledge of expert investors' views during this period. It is only presented here for illustrative purposes. In order to justify them to you, much material would have to be presented showing how investors were actually looking at the earnings of these companies during this period. Nothing would be gained by doing so, since we are only attempting to show how the principle works. Our discussion will have served its purpose if it illustrates the importance of allowing for expected earnings in one way or another. We will adopt as an approximate cost rate for the common 10.0%.

### *Cost-of-Capital*

Now we have a cost rate for the bonds, preferred and common equity, based on a ten-year period. Let's combine them and see what is the over-all cost.

| | *Capital Structure* | *Cost Rates* | *Total Cost* | *Cost-of-Capital* |
|---|---|---|---|---|
| Bonds | $ 50,000,000 | 3.64% | $1,820,000 | |
| Preferred | 12,000,000 | 4.63 | 555,600 | |
| Common Equity | 38,000,000 | 10.00 | 3,800,000 | |
| Total | $100,000,000 | | $6,175,600 | 6.18% |

These figures show the over-all cost to be 6.18%.

In future calculations of Cost-of-Capital, we will apply the cost rates for each security to the percentage which each security represents of the total capital structure.[11] For example, the above figures would be as follows:

| | *Capital Structure* | *Cost Rates* | *Cost-of-Capital* |
|---|---|---|---|
| Bonds | 50% | 3.64% | 1.82% |
| Preferred | 12 | 4.63 | 0.56 |
| Common Equity | 38 | 10.00 | 3.80 |
| | 100% | | 6.18% |

Exactly the same results are produced, and it is a much simpler way to handle the calculations.

We have previously said that an industrial company is not profitable if it earns only Cost-of-Capital. Investors expect that a utility company will be allowed to earn more than the calculated Cost-of-Capital. It must earn more in good years in order to compensate for bad years, just to achieve Cost-of-Capital on an average. Capital expenditures precede earnings, and sometimes there are extended delays before adequate earnings materialize. Because of special factors, owing to the regulated nature of the utility industry, there are inherent risks not fully covered in the Cost-of-Capital approach. Furthermore, investors in utilities should not be treated any differently, in principle, from those who invest in industrials. They should be allowed some margin above cost. Regulation should eliminate monopoly profits but not all profits. For a relatively stable type of company such as an electric, investors may expect 0.50% to 1.00% above the calculated Cost-of-Capital, depending on the circumstances. The final figure of around 6¾% is termed a fair rate of return.[12] As previously indicated, we do not present this figure as one which should be adopted for any particular electric company, since the figures on which it was based were used only to illustrate the method of approach.

Would this figure for our electric company necessarily represent a Cost-of-Capital for another type of company? Decidedly not, because the risk factor may be quite different.

## THE RISK FACTOR

Broadly speaking, Cost-of-Capital includes two elements. One element is the amount necessary to induce people to invest their money rather than hold it idle or spend it on consumer goods. In economic theory, this is termed *pure interest.* The other element is the amount necessary to compensate investors for the *risk* they take in placing their money into a particular project. As a very broad principle, it is the nature of the company and its risk which determines the Cost-of-Capital, and not the way the capital structure pie is divided between various types of securities. Obviously, the risk element will vary widely from one type of business to another. Let us illustrate this idea with some assumed figures in the following way. (See above.)

| | | *Cost-of-Capital* | | | |
|---|---|---|---|---|---|
| *Type of Investment*[1] | *Company ROI* | *Non-Risk* | *Risk* | *Total* | *Profit* |
| Govt. Securities (long) | | 4% | 0% | 4% | 0% |
| Electric Utility | 6% | 4 | 2 | 6 | 0 |
| Retail Store | 9 | 4 | 4 | 8 | 1 |
| Steel Company | 10 | 4 | 7 | 11 | (Loss) 1 |

[1] These figures are only for explanatory purposes and do not represent actual returns on investment or Cost-of-Capital.

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[11] The cost rates for various classes of capital must be weighted by the proportion which such capital represented in the companies from which the cost rate evidences were obtained, not by the weights which the company itself reflected, or some arbitrary or "ideal" proportion.

[12] Fair rate of return should be applied to reproduction cost of new properties less observed depreciation or at least to "fair value." If applied to original cost of property, a higher rate of return should be allowed in order to compensate for current value of the property. See comments in last part of this chapter under the heading "Maintenance of the Integrity of the Dollar."

These figures speak for themselves. A profit is only earned after all costs are covered, including Cost-of-Capital.

Even in the utility field there is a difference in the risk factor. The earnings fluctuation is a measure of the risk of a business. This was pointed out in Chapter II, "Capital Structure." The chart on fluctuation in earnings showed that earnings of the industrial companies were most volatile, with the telephone business somewhat less so and the electric industry least volatile. This variation indicated the need for the lowest debt ratio for the industrial companies, a higher ratio for the telephone industry, and for the electric, the highest. It also is one reason for a variation in Cost-of-Capital for the three groups. It should not be assumed that a study of past earnings will necessarily reveal all of the inherent risks connected with the investment in a company. Circumstances may not have occurred in the past which put to test all the risks in an enterprise. Potential risks have to be weighed by considering the characteristics of a company.

Now that we have developed a background in the intricate subject of Cost-of-Capital, we will move on to the industrial field.

## COST-OF-CAPITAL FOR AN INDUSTRIAL COMPANY

### *Capital Structure*

In order to determine Cost-of-Capital for an industrial company, we must, as usual, start with capital structure. In Chapter II we presented the capital structure for the 125 companies in the Moody's Industrial Common Stock Average. The arithmetic average for these companies was approximately as follows:

| | |
|---|---|
| Long-term debt | 15% |
| Preferred | 4 |
| Common equity | 81 |
| | 100% |

We will use these figures for illustrative purposes.

We will not spend time on the cost rates for the bonds and preferred stock, because we have already illustrated the technique in determining their cost rates for our electric company. The proportion of debt and preferred stock are much smaller in our present example, and therefore they will have less effect on the over-all cost. We will take as assumed rates 4% for bonds and 5% for preferred stock as average figures for both a 5-year and 10-year period.

### *Cost Rate for Common Equity*

Let us now try to obtain a cost rate for the common which will tie in with our capital structure. Since we relied on the average capital structure for the 125 companies included in Moody's Industrial Common Stock Average, we will use this stock average to get the cost rate for the common. The figures are shown in the table which follows.

In the second column, the market price is adjusted for 15% for underpricing, to approximate the net proceeds that would be received for new issues. A higher allowance is required for underpricing for industrials than for our electric companies.

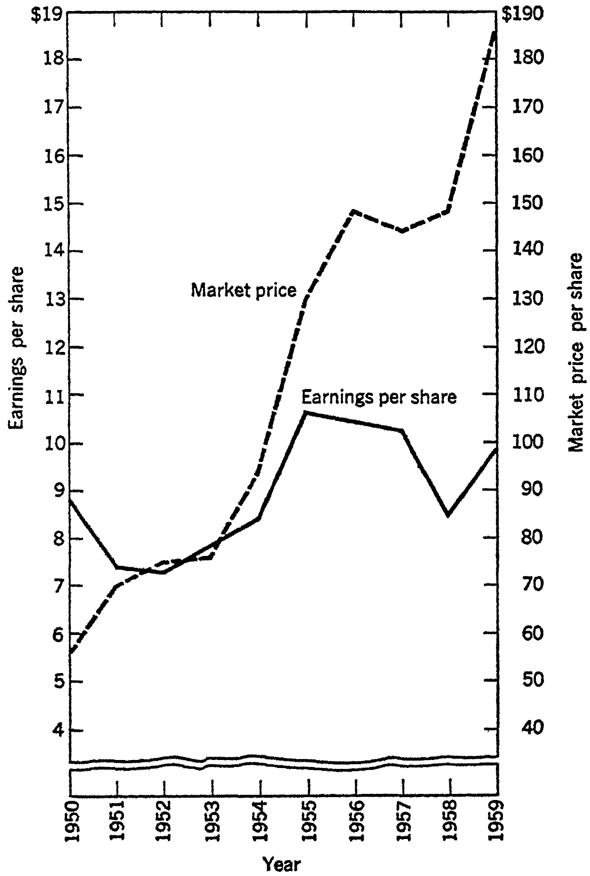
MOODY'S COMMON STOCK AVERAGE
125 Industrials[1]

| | *Market Price per Share* | *Market Price per Share Adjusted for 15% for Underpricing* | *Earnings per Share* |
|---|---|---|---|
| 1959 | $186.26 | $158.32 | $9.85 |
| 1958 | 149.81 | 127.34 | 8.31 |
| 1957 | 143.65 | 122.10 | 10.27 |
| 1956 | 149.41 | 127.00 | 10.35 |
| 1955 | 130.66 | 111.06 | 10.51 |
| 1954 | 95.81 | 81.44 | 8.38 |
| 1953 | 76.05 | 64.65 | 7.71 |
| 1952 | 75.63 | 64.29 | 7.18 |
| 1951 | 70.72 | 60.12 | 7.37 |
| 1950 | 57.83 | 49.16 | 8.45 |

[1] Each stock is weighted by the number of its shares currently outstanding. In computing the averages, adjustments are made for all stock splits and stock dividends, so that the series are comparable throughout the period covered. Market prices are annual averages of end-of-month figures.

Again, we must decide what to do about expected earnings. In the chart which follows, the market price and earnings per share are presented, in order to show a picture of what happened. The earnings generally trended upwards, with a dip in the first and next to the last years. Earnings at the end were 16% above the first year. Market prices showed a sharp upward movement, indicating that investors were more and more optimistic regarding future prospects during the period.

MOODY'S COMMON STOCK AVERAGES
125 INDUSTRIALS



On the average during the first few years, the earnings per share in each year divided by market price adjusted in the same year might be satisfactory as a cost rate, since earnings did not show any marked upward trend. During the latter part of the period, it would appear that investors were definitely expecting future earnings increases. In the next table are shown the cost rates figured on the basis both of earnings to price adjusted in the same year, and also of earnings to price adjusted in the previous year, in order to make some allowance for the investors' appraisal of expected earnings.

| | *Earnings per Share to Market Price Adjusted in Same Year* | *Earnings per Share to Market Price Adjusted in Previous Year* |
|---|---|---|
| 1959 | 6.2% | 7.7% |
| 1958 | 6.6 | 6.8 |
| 1957 | 8.4 | 8.0 |
| 1956 | 8.1 | 9.3 |
| 1955 | 9.4 | 12.9 |
| Average 1955-1959 | 7.7 | 8.9 |
| 1954 | 10.2 | 12.9 |
| 1953 | 11.8 | 11.9 |
| 1952 | 11.1 | 11.9 |
| 1951 | 12.3 | 14.9 |
| 1950 | 17.1 | |
| Average 1950-1954 | 12.5 | 12.9 |

In order to make a rough approximation for the cost rate on the common, we will use for the latest five years, the average of the earnings per share divided by the market price adjusted in the previous year. For the ten-year average, we will use these same figures combined with the figures in the first five years for the earnings per share divided by the market price adjusted in the same year. The results are as follows:

Most recent five years 1955-59—8.9%
Most recent ten years 1950-59—10.7%

### *Cost-of-Capital*

Now we can apply our cost rates to the capital structure to obtain the Cost-of-Capital.

By the time we come to the final conclusion regarding Cost-of-Capital we are not interested in tenth's of a percent. Because of all the problems involved in arriving at a final figure and all the judgment that must be applied, it is foolish to think that any measurement could be so close. We are interested in a figure which is correct in the general magnitude. For a relatively stable electric company, we may be able to shave the results somewhere between full percentage points, but when we get to industrial companies, which have a higher range in Cost-of-Capital, we should not expect our goal to be better than within a full percent, and from a practical point of view there is no need to come closer.

*Five-Year Average*

| | *Capital Structure* | *Cost Rates* | *Cost-of-Capital* |
|---|---|---|---|
| Debt | 15% | 4.0%[1] | 0.60% |
| Preferred | 4 | 5.0[1] | 0.20 |
| Common Equity | 81 | 8.9 | 7.20 |
| | 100% | | 8.00% |

*Ten-Year Average*

| | *Capital Structure* | *Cost Rates* | *Cost-of-Capital* |
|---|---|---|---|
| Debt | 15% | 4.0%[1] | 0.60% |
| Preferred | 4 | 5.0[1] | 0.20 |
| Common Equity | 81 | 10.7 | 8.67 |
| | 100% | | 9.47% |

[1] No specific figures were presented to arrive at the cost rates for debt and preferred. The figures shown were assumed sufficiently within the realm of reasonableness for the present purpose.

Thus it would appear that, on the average, Cost-of-Capital for our composite company, representing large, well-established companies, may be around 9% after taxes. This figure may be somewhat low, because it is questionable whether sufficient allowance was made in the common stock cost rate for investors' expectations for future earnings in the last few years of the ten-year period.

These figures should not be used for a particular company, because:

1. They are just averages. Each company has special characteristics which affect its Cost-of-Capital and which require a tailor-made job.
2. Small, less well known companies have to pay substantially higher rates for all types of securities.
3. New projects carry risks which may be quite different from the risk for a company as a whole.
4. No precise effort was made in the use of the Moody's industrial Common Stock Average to determine to what extent the earnings-price ratio gave consideration to the investor's view of expected earnings. As stated above, the allowances which were made would seem to understate the cost rates.

The Cost-of-Capital figure does not make any allowance for the amount that should be earned above Cost-of-Capital for a complete profit goal. We suggest ½% to 1% for this amount for a relatively stable electric utility company. We would expect it to be somewhat more for an industrial company, but certainly our figure of 9% should be raised to at least 10%. To some extent, the allowance for a particular company will depend on the way Cost-of-Capital itself was figured. Was it figured on a tight basis with all figures down to a minimum, or was it on the more liberal side? How much padding does the company use in estimates of sales and expenditures in a new project in order to absorb errors. No effort will be made to name a specific allowance. Each company will have to decide this question for itself. However, in all the discussion which follows, while Cost-of-Capital will be referred to as the goal, it should be understood that the goal for a specific company should be a larger figure.

## EXAMPLES OF ACTUAL COMPANIES

Let's take a quick look at two actual companies which did not have a general upward trend in earnings. They are actual companies but will be referred to as Company *A* and Company *B*.

*Company A—Food Business.* The capital structure was relatively simple, as follows:

| | *Average 1950-59* | *Average 1955-59* |
|---|---|---|
| Debt | 0.7% | 0.5% |
| Preferred | 14.7 | 13.5 |
| Common Equity | 84.6 | 86.0 |
| | 100.0% | 100.0% |

We will disregard the negligible amount of debt and use as our capital structure the figures shown above, rounded off. The yield on the preferred stock based on the average high and low market price was as follows:

| | | | |
|---|---|---|---|
| 1959 | 4.57% | 1954 | 3.93% |
| 1958 | 4.41 | 1953 | 4.19 |
| 1957 | 4.55 | 1952 | 4.10 |
| 1956 | 4.23 | 1951 | 4.07 |
| 1955 | 3.92 | 1950 | 3.86 |

Adjusting these figures by an approximate yield basis of 0.40% to obtain a rough equivalent yield on net proceeds for new offerings results in the following averages.

| | |
|---|---|
| Most recent five years | 1955-59—4.7% |
| Most recent ten years | 1950-59—4.6% |

The earnings per share and market price of common were as follows:

| | *Market Price Average High and Low* | *Earnings per Share* |
|---|---|---|
| 1959 | $52¾ | $3.57 |
| 1958 | 46⅞ | 3.18 |
| 1957 | 38¾ | 3.18 |
| 1956 | 37⅛ | 2.90 |
| 1955 | 41⅜ | 2.59 |
| 1954 | 41⅛ | 2.85 |
| 1953 | 36 | 2.61 |
| 1952 | 32⅝ | 2.56 |
| 1951 | 32½ | 2.30 |
| 1950 | 35½ | 3.08 |

In view of this rather level earnings record, it would appear that the relationship of market price adjusted to earnings in the same year would have some significance for Cost-of-Capital purposes. Adjusting the market prices for 15% for underpricing and dividing the results into the earnings per share would give a cost rate for the common as follows:

| | | | |
|---|---|---|---|
| 1959 | 8.0% | 1954 | 8.3% |
| 1958 | 8.0 | 1953 | 8.5 |
| 1957 | 9.6 | 1952 | 9.3 |
| 1956 | 9.2 | 1951 | 8.3 |
| 1955 | 7.4 | 1950 | 11.2 |

Most Recent Five-Year Average 1955-59—8.4%.
Most Recent Ten-Year Average 1950-59—8.8%.

The resulting Cost-of-Capital would, then, be as follows:

| *Most Recent Five Years 1955-59* | *Capital Structure* | *Cost Rates* | *Cost-of-Capital* |
|---|---|---|---|
| Preferred | 14% | 4.7% | 0.7 % |
| Common Equity | 86 | 8.4 | 7.21 |
| Total | 100% | | 7.91% |

| *Most Recent Ten Years 1949-58* | *Capital Structure* | *Cost Rates* | *Cost-of-Capital* |
|---|---|---|---|
| Preferred | 15% | 4.6% | 0.7% |
| Common Equity | 85 | 8.8 | 7.5 |
| Total | 100% | | 8.2% |

A Cost-of-Capital for this company for its existing business may be in the neighborhood of 8%[13] after taxes.

This was a relatively simple situation. Now take a look at one that is more complicated.

*Company B—Textile Company.* The capital structure of this company consisted solely of common equity. The earnings per share and market price were as follows:

| | *Market Price Average High and Low* | *Earnings per Share* |
|---|---|---|
| 1959 | $35½ | $4.31 |
| 1958 | 20½ | 1.02 |
| 1957 | 20⅝ | 0.93 |
| 1956 | 35 | 1.72 |
| 1955 | 48¼ | 5.22 |
| 1954 | 39½ | 4.48 |
| 1953 | 37½ | 5.74 |
| 1952 | 39¼ | 5.42 |
| 1951 | 45 | 5.01 |
| 1950 | 35 | 6.23 |

Adjusting the market prices for 15% for underpricing and dividing the results into the earnings per share produces the following:

| | | | |
|---|---|---|---|
| 1959 | 14.3% | 1954 | 13.3% |
| 1958 | 5.9 | 1953 | 18.0 |
| 1957 | 5.3 | 1952 | 16.3 |
| 1956 | 5.8 | 1951 | 13.1 |
| 1955 | 12.7 | 1950 | 21.0 |

Average 1955-59—8.8%.
Average 1950-59—12.6%.

This pattern is not an easy one to interpret. The wide fluctuation in earnings produced some extremes in the relationship of earnings per share to market price adjusted figures which were obviously not representative of Cost-of-Capital. When earnings were very high, investors were obviously expecting that the level would not hold. When they were very low, investors were anticipating an increase. From this brief analysis, it would appear that the ten-year average might be representative and that the Cost-of-Capital might be in the neighborhood of 13% after taxes. This case illustrates how various factors may enter into the picture, calling for judgment in interpreting the figures. Of course, in coming to a final conclusion a more detailed study would have to be made for this company.

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[13] This figure is too low to the extent that it may fail to allow for investors' anticipation of some possible future growth in earnings.

Interpreting the cost rate for common may entail a discussion with expert security analysts, thoroughly familiar with the company and the industry in which it operates. Such a step may be helpful in understanding how investors may have viewed the earnings.

## THE RESULTS OF CORPORATE EARNINGS

Before reading this chapter you may have thought that Cost-of-Capital was much smaller. If you are still hesitant to accept fully its magnitude, reflect on the fact that profits are hard to make and that there is substantial risk in employing capital in our highly competitive and dynamic economy. Many companies at times do not make any money at all. Some end up with losses. The following quotations from editorials on profits may help hammer this point home:

> Some companies make more than the average, and many make no profit at all. In every year since 1915 at least 25% of all corporations have operated at a loss. This year the figure will probably be at least 30%. The improvement since 1939 shows a much healthier economy. But it does not indicate that profits are easy to make.[14]

The other editorial had this headline: "Score on the Auto Makers—1,854 Started; 8 Still Going." It then went on to explain how few car companies survived of all those started. There was an investor, or investors, in each one of those companies. To quote one passage:

> The odds against a new motor car company today are something like 44 to 1. With taxes what they are, the high cost of tooling a plant, the need for expensive research—just to name a few of the expenses—a new business enterprise of any kind starts today with two strikes on it.[15]

This highlights the need for a company to set a high goal for new projects, so that its successful projects will make up for those on which no profit is made and for losses on its unsuccessful ones. Only thus can a company gain a satisfactory over-all return on capital.

The return after taxes on total capital structure for the 125 companies in the Moody's Industrial average in the five years 1954-59 may be summarized as shown below.

| | *Losses* | *0 to 4.9%* | *5.0% to 9.9%* | *10.0% to 14.9%* | *15.0% to 19.9%* | *20% and over* |
|---|---|---|---|---|---|---|
| No. of Companies | 1 | 3 | 56 | 46 | 15 | 4 |

Some did poorly while others were quite successful. The arithmetic average of the percent returns of all the companies was 10.7%. On the average, they earned slightly above the Cost-of-Capital. This was in a relatively prosperous period for industry.

The above figures make no allowance for the change in the value of the dollar, a very important factor. It will be discussed briefly in the last part of this chapter under the heading "Maintenance of the Integrity of the Dollar."

Vigorous application of the Anti-Trust Laws is essential in order to maintain strong competition, prevent monopoly profits and assure fair prices in our system of private capital. However, as long as competition does exist, it should be recognized that successful companies should make high profits. The danger of losses is so great that it is only through good profits by the successful companies that our capital as a whole can be preserved. Adequate profits in the face of strong competition are a benefit to society. They mean success for all parties affected. Since losses are not limited on the downside, profits should not be limited on the upside except by competition.

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[14] *Business Week,* Oct. 17, 1953, page 192-3, Serial No. 1259. McGraw-Hill Publishing Company, Inc., Editorial —"Profits . . . How High Are They?"

[15] Leslie Gould in the *New York Journal-American,* October 29, 1953.

## OTHER CONSIDERATIONS

### *What Cost-of-Capital Applies To*

The necessity of having a thorough understanding of the principles involved in calculating the Cost-of-Capital has been emphasized throughout the chapter. Now that you have this background, it appears worthwhile to develop more fully several points already touched upon and to inject a few additional ones.

Thus far, we have talked about the cost of long-term, permanent capital as stated on the right-hand side of the balance sheet. When a company considers launching a new project, the management has to think of the cost of bricks, mortar, machines and inventory. To what part of the total assets should the cost of long-term capital be applied? The answer is, to all elements which will require permanent capital.

There is a certain float of current liabilities, which, although paid in a short time, remain continually on the books of a company. They may be looked upon as supplying part of the assets represented by Current Assets. Also, a seasonal expansion in inventory is often financed through temporary bank loans. Such inventory does not rely on long-term capital. Long-term capital *does* provide the Net Current Assets, that is, Current Assets minus Current Liabilities. If some permanent capital is required to carry inventory, then that inventory must be charged with the cost of that capital. To obtain the average cost rate for all inventory, the rate charged for the inventory supported by permanent capital can be averaged with the cost of short-term capital required to support the rest of the inventory. To the extent that inventory turns more than once each year, it would be charged with the full rate for the Cost-of-Capital, but that rate would only be applied to each part of the inventory for the length of time it remained in stock.

There seems to be a general consensus that new projects are appraised normally in terms of the land, building and machinery, that is, the fixed assets. This stems naturally from the fact that the charters of most companies require approval of the board of directors for the appropriations of capital into fixed assets, but leave the control of working capital and its appropriations to the management. Many a project, if viewed in line with the total permanent assets, may become unattractive when it would otherwise appear attractive.

This point may be summarized by saying that in order for a company to be a going concern, long-term capital costs must be applied to all elements representing a relatively permanent investment and for which long-term capital is required. In comparing ROI with the Cost-of-Capital goal, you must be certain to use the same divisor or make some adjustment for any difference in the divisor.

Here is a simple example to illustrate the point:

| *Assets* | | | *Liabilities* | |
|---|---|---|---|---|
| Current Assets | | $200 | Current Liabilities | $100 |
| Plant | 150 | | Long-Term Debt | 50 |
| Depreciation | 50 | | Common Equity | 150 |
| Net Plant | | 100 | | |
| Total | | $300 | Total | $300 |

If the Cost-of-Capital were 10%, as determined from cost rates on long-term debt (5.0%) and common equity (11.7%), then, shifting to the lefthand side, the equivalent rates on various bases would be as follows without allowing for the income tax savings from interest charges, which we will discuss shortly.

| | |
|---|---|
| On Total Assets ($300) | 6.7% |
| On Net Plant ($100) plus Net Current Assets ($100) | 10.0% |
| On Net Plant ($100) | 20.0% |
| On Gross Plant ($150) plus Net Current Assets ($100) | 8.0% |
| On Gross Plant ($150) | 13.3% |

What if our company had a new plant worth $50 and financed it by a lease rather than by long-term debt? The balance sheet would be as follows:

| *Assets* | | | *Liabilities* | |
|---|---|---|---|---|
| Current Assets | | $200 | Current Liabilities | $100 |
| Plant | 100 | | | |
| Depreciation | 50 | | Common Equity | 150 |
| Net Plant | | 50 | | |
| Total | | $250 | Total | $250 |

Let us make one assumption: the equivalent interest rate in the lease financing is the same size as the interest rate on the debt in our previous example.

The company will still be using the plant it has lease financed and the cost on the total capital will not change. The plant did not just get up and walk away when it was leased. Equity will be needed to make the lease possible. However, because the leased plant is no longer in the Assets and there is no debt shown, the problem arises as to how to handle the situation.

One way to treat it, for Cost-of-Capital purposes, is to put the plant back on the asset side and the equivalent liability on the liability side. Then the picture is exactly the same as we had in our original example. If a company has some plants which are leased and some which are owned, then it may be necessary to use this approach in order to be able to compare the Cost-of-Capital with the operating results of the various plants.

If the leased plant is not put back on the balance sheet, then it will only have the common equity to use in calculating Cost-of-Capital. Referring back to our first example, it would be 11.7%. In transferring to the asset side, the rate on the remaining assets would have to be correspondingly higher in order to produce this 11.7% on the common equity. How the problem can best be handled will depend on all the circumstances surrounding the particular company. Just be sure to see the picture clearly. Basically, you haven't changed the over-all Cost-of-Capital merely because of the mechanics of lease financing.

There may be a difference in the interest rate between lease financing and debt financing. There may be other special considerations you will have to take into account in a complete application of Cost-of-Capital where lease financing is concerned. Be sure to think through clearly all the angles. Remember what was stated above: you haven't economically eliminated any plant in your production process. We will have a few more words to say on this subject under the topic "Discounted Cash Flow."

### *Before or After Taxes*

So far we have been computing Cost-of-Capital after Federal income taxes without allowing for the tax savings due to any interest charges. Have we been correct in doing so? That is a very natural question, since income taxes are figured after deducting interest payments but before earnings available for the equity (preferred and common) securities. The answer is that such a policy seems to be the best approach in the first instance, but a word of explanation should be added. Cost-of-Capital must first be determined from the point of view of what is required by investors to persuade them to put their money into an enterprise. Investors do not alter their ideas of the return they require as corporate Federal income taxes are changed.[16] For example, if investors in bonds wanted a 4% interest rate, it would make no difference to them whether the company selling the bonds had to pay a 52% tax rate or 48%.

This does not deny the fact that from the company's point of view, interest has a lower net cost than an equal amount of income required for equity, because of the tax factor. We discussed this in Chapter II, "Capital Structure," as our fifth Determinant, and pointed out how it should be weighed in establishing an appropriate capital structure. In considering the ultimate Cost-of-Capital to the company, this point must be kept in mind. In other words, Federal income taxes do not reduce the interest which has to be paid to investors, but the interest will reduce taxes for the company.

---

[16] Leaving out, of course, the entirely different question of whether a change in the corporate tax rate might change the risk of the enterprise.

Let's take some simple examples.

| | *Capital Structure* | *Cost Rates* | *Cost-of-Capital* |
|---|---|---|---|
| Long-Term Debt | 0.0% | | |
| Common Equity | 100.0 | 10% | 10% |
| | 100.0% | | 10% |

If the company had a total capital structure of $100,000,000, the income figures, for our purpose, assuming a 50% tax rate, would be:

| | |
|---|---|
| Gross Income before Taxes | $20,000,000 |
| Income Taxes | 10,000,000 |
| Available for Capital Structure | $10,000,000 |

The Cost-of-Capital rate after taxes would be 10%; and, before taxes, 20%. Now let's add some debt.

| | *Capital Structure* | *Cost Rates* | *Cost-of-Capital* |
|---|---|---|---|
| Long-Term Debt | 20.0% | 5.0% | 1.0% |
| Common Equity | 80.0 | 11.3 | 9.0 |
| | 100.0% | | 10.0% |

Again, if the company had a total capital structure of $100,000,000, the income figures for our purpose, assuming a 50% tax rate, would be as follows:

| | |
|---|---|
| Gross Income before Taxes | $19,000,000 |
| Interest | 1,000,000 |
| Balance | 18,000,000 |
| Income Taxes | 9,000,000 |
| | $ 9,000,000 |

The cost rate after taxes would still be 10% but, before taxes, 19% instead of 20%.

This may be further explained in the large table below. It shows three rates: the rates to investors, the after-tax equivalent rate to the company, and the pre-tax rate to the company. The tabulations are shown with two different capital structures and tax rates for illustrative purposes.

| | | | *Cost-of-Capital* | | |
|---|---|---|---|---|---|
| | *Capital Structure* | *Rate* | *To Investors* | *To Company. After Tax Equivalent* | *To Company. Pre-tax* |
| *50% Tax* | | | | | |
| I. Common | 100% | 10.0% | 10.0% | 10.0% | 20.0% |
| II. Debt | 20 | 5.0 | 1.0 | 0.5 | 1.0 |
| Common | 80 | 11.3 | 9.0 | 9.0 | 18.0 |
| | 100% | | 10.0% | 9.5% | 19.0% |
| *40% Tax* | | | | | |
| I. Common | 100% | 10.0% | 10.0% | 10.0% | 16.7% |
| II. Debt | 20% | 5.0% | 1.0% | 0.6% | 1.0% |
| Common | 80% | 11.3 | 9.0 | 9.0 | 15.0 |
| | 100% | | 10.0% | 9.6% | 16.0% |

Having reached an understanding of Cost-of-Capital by approaching it from the investor's point of view, it is important in its application that you do take into account the effect of the interest factor for tax purposes. Which rate is used for this purpose, the after-tax equivalent or the pre-tax figure, will depend on how you intend to use the results of your calculations.

### *Varying Risks from Time to Time and Project to Project*

Cost-of-Capital may vary from time to time due to many factors. There may be variations in the supply and demand for types of securities as well as for all capital. The general risk element may be evaluated differently by investors at different times. When a recession is expected by investors, they will tend to increase their evaluation of the risk factor.

In a boom period, there may be a decrease in the cost rate for common stock capital because investors feel that there is less risk in common stocks. However, great caution must be used in interpreting an apparent decrease in the common stock cost. Remember that the cost rate on the common is based on expected earnings. In a boom period, the ratio of current earnings to market price may be low. This may or may not be an indication of common stock investors' willingness to accept a lower rate. It could be due to investors' greater confidence in the future and their willingness to pay today for higher earnings that they expect will materialize in the future. Whether there is a decrease in the cost of common is dependent on whether they will accept a lower rate on those expected earnings, and not on the relationship to current earnings.

The above remarks raise the question as to whether projects which come up in generally adverse business conditions have a more rigid test to meet; conversely, do projects which may have less merit, but come up in years when business conditions are better, have an advantage? This problem is a real one for a company which has to keep pace with an expanding market in several product lines. In the first place, it has already been stressed that "spot" Cost-of-Capital should never be used. Secondly, the whole problem must be viewed in broad perspective.

Cost-of-Capital is only one of the many factors which management must weigh in its final judgment in determining whether to expand. If, as a simple example, its Cost-of-Capital goal were 15% after taxes, it might decide not to expand during a boom if it could only realize 15% on a new project, because it could not maintain that 15% during more competitive conditions. On the other hand, it might decide to expand during a depression if it could obtain 10%, if under more normal conditions it could expect to make 20%.

A company's own Cost-of-Capital may vary over a period of years, depending on how investors view such factors as a change in the nature of the business, management's ability to expand successfully, changes in financial policy, greater investor knowledge about the company through an expanded investor relations program, etc.

If there is any substantial difference in risk in a company's products, then there must be a difference in the Cost-of-Capital goal. One question which may be raised is whether each product should meet the Cost-of-Capital test. The answer seems obvious. This has already been touched on. If any capital is invested which does not meet its Cost-of-Capital, then the deficit must be made up on some other project to which this particular capital contributes. One company put it this way: about one-third of new capital is needed to expand its existing business at the average profit margin, one-third is required for non-profitable projects to stay in business, and one-third is needed for new projects on which a high profit should be made. The latter third must make up for the profitless third.

It has been emphasized before that if a company is going into an entirely new project from its general line, the risk element might be quite different from that of the rest of its business. The emphasis in more and more companies today is to diversify in order to offset either seasonal or cyclical patterns of existing product lines. It would be surprising, however, if most companies made this transition in their thinking from past earnings performance and Cost-of-Capital to the increased hazard in a new field. Generally, they do not do as well as they hoped at the outset and have to learn quite a few lessons. Consequently, the position of the stockholder is impaired. The allowance for the risk element should be increased for new projects which are beyond prior history.

## OTHER RELATED TESTS

As emphasized throughout this chapter, we have been talking about goals, and not the methods of testing the profitability of a project used by industrial companies; that is the other side of the coin—to which we will now turn.

Unless correctly interpreted and understood in terms of their significance to the Cost-of-Capital, tests of profitability may be misleading. First, we will discuss the significance, in terms of Cost-of-Capital, of maintenance of earnings per share of common stock, and of the relationship of market value of common to book value.

A rough rule of thumb sometimes used as a test of the profitability of a new project, is that capital should be returned in a certain number of years. A more sophisticated project analysis formula is the discounted cash flow approach. We will also discuss these two approaches to project analysis in order to show how they relate to a profit goal. We will give you enough on the discounted cash flow method so that you will be able to apply it.

### *Maintenance of Earnings per Share*

A new project may be tested by the fact that it produces sufficient return to maintain earnings per share on common stock. If it is correctly interpreted, there is nothing wrong with this test. It is merely another way of stating the cost of new common capital as we have previously defined it. However, in order to compensate investors fairly, it is not necessarily past earnings per share which must be maintained; it is the earnings per share expected by investors.

To carry the picture to an extreme, suppose that a stock is earning $5 per share and selling at $100, but that earnings are expected to double to $10 in the future. Then the company would have to have as its goal for a new project a sufficient profit to maintain the $10 per share earnings after allowing for financing costs, etc. The test thus conforms to the Cost-of-Capital approach. All of the qualifications observed in that approach must be kept in mind in the Maintenance of Earnings Per Share method. As one example, if the capital for a new project is raised through debt, it must be recognized that the added debt may well increase the risk to the common equity holder. If so, the anticipated earnings on the new project would have to increase rather than just maintain the earnings per share. Otherwise, with added risk and the same expected earnings, the market price of stock would be bound to decrease.

Remember that maintenance of expected earnings per share through new capital gives no clue as to whether earnings on capital already are adequate.

### *Relationship of Market Value to Book Value*

Book value per share of common stock is obtained by dividing the stated value of the common stock plus common stock premium, capital surplus and earned surplus by the number of shares outstanding. The resulting figure for an industrial company may or may not be very meaningful. It has some significance only if the assets are fairly valued, properly depreciated, there are no hidden assets and there are no mere bookkeeping items on the asset side of the balance sheet. If all those qualifications are met, then book value per share is of some interest.

Such a book value would be representative of the assets valued on historical cost. Industry tends to function on current and not historical or "spot" value. Current value of assets approaches reproduction cost new less observed depreciation. Therefore, for a more significant figure for book value, there should be an adjustment for an appraisal of the assets on the basis of current value. An industrial company may not wish to go to the trouble of accurately estimating a value of all its assets in detail. Nevertheless, it should be realized that such a step is necessary to arrive at a correct result. At least such a mental adjustment of book value should be made. This matter is further discussed under the next heading.

The relationship of market price to book value is not easily understood, but management should appreciate the significance of the concepts involved. Let's take a simple case to start with. Assume that a company's earnings are absolutely stable with no growth prospects,[17] and that the *book value on a current value basis* is $85 per share. Further assume that we have an average stock market, with neither boom nor recession, and that the stock sells for $100. Then, with a new offering of stock, if 15% is allowed for underpricing, the company would just net $85 per share. This tells us that under these circumstances the company is just earning its bare Cost-of-Capital.[18]

What if the figures were the same except that there were prospects of growth in earnings which were known to investors? Then, in our example, the actual earnings rate would be below the bare Cost-of-Capital, because the stock would be held up by the prospect of higher earnings and not just on existing earnings. If a company is earning an adequate return, a stock should sell at a good margin above book value on a current value basis even during average stock market conditions, for two principal reasons: 1. To reflect the earnings above bare Cost-of-Capital, 2. Because the price reflects investors' appraisal of growth prospects in earnings. During a bull stock market, the market price should be substantially above book value.

| Column I | II | III | IV | V | VI |
|---|---|---|---|---|---|
| | *Before Taxes and Depreciation* | *After Depreciation but Before Taxes* | | *After Depreciation and After 50% Tax Rate*[1] | |
| *Number of Years in which Capital Returned* | *Return on Investment* | *Return on Investment* | | *Return on Investment* | |
| | | *3% Deprec.* | *5% Deprec.* | *3% Deprec.* | *5% Deprec.* |
| 1 yr. | 100% | 97% | 95% | 48.5% | 47.5% |
| 2 yrs. | 50 | 47 | 45 | 23.5 | 22.5 |
| 3 yrs. | 33⅓ | 30⅓ | 28⅓ | 15.2 | 14.2 |
| 4 yrs. | 25 | 22 | 20 | 11.0 | 10.0 |
| 5 yrs. | 20 | 17 | 15 | 8.5 | 7.5 |

[1] Assuming no capital is raised by debt on which interest is deductible for income tax purposes.

Book value in relation to market value is not a gauge as to future projects. Just because a company's stock is below a correct book value does not mean that it should not expand. It means that its past results have not been up to investors' requirements. Some of the past investment has been lost. In fairness to investors, management should do everything possible to correct this situation. At least, when the company launches a new project, it must be certain that this time it will be successful. Of course, sometimes a new project has to be undertaken in order to save old investments. That involves more complicated calculations. In any event, it should be made certain that good money is not being thrown after bad.

### *Return of Capital in One to Five Years*

On the surface, it would seem that if the cash flow from a project were sufficient to return the total investment in five years, the project would be quite successful. However, if allowance is made for income taxes and adequate depreciation, it will be seen that the amount available for Cost-of-Capital is relatively small. The significance of these comments can be gathered from the table given above. To simplify it, no adjustment is made for present value or compounding.

In column II is shown the return on investment before depreciation and Federal income taxes for the various number of years in which capital is returned, shown in column I. Even

[17] This would be an unlikely situation. If a company retains part of its earnings after dividend payments and earns a satisfactory rate on those retained earnings, there should be a growth in earnings per share.

[18] Provided the rates on senior securities are at a current rate.

for return of capital in five years, the return looks good at 20%. However, now let's look at column IV, which shows the return after 5% depreciation. It is 15%. The five-year rule of thumb is beginning to look less sound.

Let us not fool ourselves! The project will not produce earnings for the investors until after Federal income taxes are paid. And when we refer to column VI, we note that the five-year rule of thumb produces a return of less than 10% and is thus probably unattractive. We can say practically the same thing for the four-year period unless there is relatively little risk in the project.

If a company uses this type of formula to determine whether to go into a new project, it should be certain that it is based on an adequate allowance for depreciation, on a Federal tax rate that will be appropriate for the next few years (with adjustments for its own tax deductions such as interest) and on a sufficiently high Cost-of-Capital to assess adequately the risk in the project.

The statement of this formula on such a simplified basis does not take into consideration the number of special situations which a company may face. For example, it may be necessary to operate a new undertaking at a loss for the first few years. If such is the case, for the project to be worthwhile, it should be possible in a few years after it becomes profitable not only to make up the losses, but to produce a satisfactory profit on the average, including the first few years. The fact that profits are postponed obviously produces another element of risk. Here is a good example of how judgment, rather than pure figures, will have to be relied upon in making the final decision.

A word might be said here about the problem of abandonment of property or change in its use. The problem will involve the return from the project, in relation to its value, either from abandonment or alternate use. This rate of return must be compared by some method with the profit goal in order to determine what action to take. Similar types of questions are involved if an old plant is to be improved.

### *Discounted Cash Flow*

The above test of return of capital in a certain number of years is a simple method. Many elaborate tests have been devised. It is most important to realize that the purpose of all such tests is to show, in one way or another, the profitability of a project. The goal itself must come from the concept of the Cost-of-Capital as it has been discussed in this chapter.

Great care must be taken to understand the relationship between the project analysis test and the goal. If they are not figured on a comparable basis, allowance must be made for any difference in the methodology, or else the goal itself will be misleading.

The method we will discuss now involves a study of the cash outlay and returns on a discounted cash flow basis. We will show how it works, how it relates to Cost-of-Capital—and how easy it is to come up with ridiculous results if a company does not apply the method properly.

There are two steps. The first is to estimate the cash flow for the project over its life span. The second is to discount this cash flow at different rates until we find the rate that gives a present value of zero. This is the profitability rate of the project.

The cash flow includes all cash outlays and returns. The outlays include expenditures for plant, equipment, working capital, etc. They are designated by a negative sign (—). The returns include all income after taxes, depreciation and any salvage or remaining value after the project is at an end.

We will start with a very simple example in order to make it easy for you to see the picture. Let's assume that our project is all wound up in two years and that the cash flow, that is, outlays and returns, are as follows:

| *Year* | *Cash Flow* |
|---|---|
| 0 | – $1,770,000 |
| 1 | + 1,000,000 |
| 2 | + 1,000,000 |

Now we are ready to proceed with the Discounted Cash Flow analysis. The project produced a gain in cash flow of $230,000. What does the cash flow represent as a percent return? We wish to know the rate that will cause the entire cash flow for the project to discount to a zero present value. As stated above, that rate will give us the profitability of the project, which we will wish to compare with the after-tax equivalent rate for our goal based on Cost-of-Capital.

The mechanics of applying the Discounted Cash Flow method, involves the use of discount factors in order to obtain the rate that will cause the entire cash flow for the project to discount to a zero present value. A discount factor is the present value[19] of $1.00 at the particular rate for the period of time.

In the table which follows, there is given the simplest of discount factors for a fairly wide variety of percentages and periods. They assume a flow of income at a particular time. They are on the basis of compounding annually. While some people prefer to use a different method for compounding, for our explanation this is not important.

DISCOUNT FACTORS[1]

THE PRESENT VALUE OF ONE

Annual Compounding

Income Received at an Instant of Time.

| Period | 8% | 10% | 12% | 14% | 16% | 18% | 20% | 22% | 24% |
|---|---|---|---|---|---|---|---|---|---|
| 0 | 1.0000 | 1.0000 | 1.0000 | 1.0000 | 1.0000 | 1.0000 | 1.0000 | 1.0000 | 1.0000 |
| 1 | 0.9259 | 0.9091 | 0.8928 | 0.8772 | 0.8621 | 0.8475 | 0.8333 | 0.8197 | 0.8065 |
| 2 | 0.8573 | 0.8264 | 0.7972 | 0.7695 | 0.7432 | 0.7182 | 0.6944 | 0.6719 | 0.6504 |
| 3 | 0.7938 | 0.7513 | 0.7118 | 0.6750 | 0.6407 | 0.6086 | 0.5787 | 0.5507 | 0.5245 |
| 4 | 0.7350 | 0.6830 | 0.6355 | 0.5921 | 0.5523 | 0.5158 | 0.4823 | 0.4514 | 0.4230 |
| 5 | 0.6806 | 0.6209 | 0.5674 | 0.5194 | 0.4761 | 0.4371 | 0.4019 | 0.3700 | 0.3411 |
| 6 | 0.6302 | 0.5645 | 0.5066 | 0.4556 | 0.4104 | 0.3704 | 0.3349 | 0.3033 | 0.2751 |
| 7 | 0.5835 | 0.5132 | 0.4523 | 0.3996 | 0.3538 | 0.3139 | 0.2791 | 0.2486 | 0.2218 |
| 8 | 0.5403 | 0.4665 | 0.4039 | 0.3506 | 0.3050 | 0.2660 | 0.2326 | 0.2038 | 0.1789 |
| 9 | 0.5002 | 0.4241 | 0.3606 | 0.3075 | 0.2630 | 0.2255 | 0.1938 | 0.1670 | 0.1443 |
| 10 | 0.4632 | 0.3855 | 0.3220 | 0.2697 | 0.2267 | 0.1911 | 0.1615 | 0.1369 | 0.1164 |
| 11 | 0.4289 | 0.3505 | 0.2875 | 0.2366 | 0.1954 | 0.1619 | 0.1346 | 0.1122 | 0.0938 |
| 12 | 0.3971 | 0.3186 | 0.2567 | 0.2076 | 0.1685 | 0.1372 | 0.1122 | 0.0920 | 0.757 |
| 13 | 0.3677 | 0.2897 | 0.2292 | 0.1821 | 0.1452 | 0.1163 | 0.0935 | 0.0754 | 0.0610 |
| 14 | 0.3405 | 0.2633 | 0.2046 | 0.1597 | 0.1252 | 0.0985 | 0.0779 | 0.0618 | 0.0492 |
| 15 | 0.3152 | 0.2394 | 0.1827 | 0.1401 | 0.1079 | 0.0835 | 0.0649 | 0.0507 | 0.0397 |
| 16 | 0.2919 | 0.2176 | 0.1631 | 0.1229 | 0.0930 | 0.0708 | 0.0541 | 0.0415 | 0.0320 |
| 17 | 0.2703 | 0.1978 | 0.1456 | 0.1078 | 0.0802 | 0.0600 | 0.0451 | 0.0340 | 0.0258 |
| 18 | 0.2502 | 0.1799 | 0.1300 | 0.0946 | 0.0691 | 0.0508 | 0.0376 | 0.0279 | 0.0208 |
| 19 | 0.2317 | 0.1635 | 0.1161 | 0.0829 | 0.0596 | 0.0431 | 0.0313 | 0.0229 | 0.0168 |
| 20 | 0.2145 | 0.1486 | 0.1037 | 0.0728 | 0.0514 | 0.0365 | 0.0261 | 0.0187 | 0.0135 |
| 21 | 0.1987 | 0.1351 | 0.0926 | 0.0638 | 0.0443 | 0.0309 | 0.0217 | 0.0154 | 0.0109 |
| 22 | 0.1839 | 0.1228 | 0.0826 | 0.0560 | 0.0382 | 0.0262 | 0.0181 | 0.0126 | 0.0088 |
| 23 | 0.1703 | 0.1117 | 0.0738 | 0.0491 | 0.0329 | 0.0222 | 0.0151 | 0.0103 | 0.0071 |
| 24 | 0.1577 | 0.1015 | 0.0659 | 0.0431 | 0.0284 | 0.0188 | 0.0126 | 0.0085 | 0.0057 |
| 25 | 0.1460 | 0.0923 | 0.0588 | 0.0378 | 0.0245 | 0.0160 | 0.0105 | 0.0069 | 0.0046 |

[1] As prepared by the Financial Publishing Company, 82 Brookline Avenue, Boston (15), Mass.

Now let's get back to our very simple example to illustrate the use of the table. We make a guess that this cash flow produces a return of 8% and apply the discount factors for that rate as follows:

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[19] The formula for present value is $\frac{1}{(1+I)^N}$, where I is the interest per period and N is the number of periods.

For example the present value of 1.00 in one year at 10% is $\frac{1}{(1+0.10)^1} = \frac{1}{1.10} = 0.9091$.

| | | *Discounting at 8%* | |
|---|---|---|---|
| *Year* | *Cash Flow* | *Discount Factors* | *Present Value* |
| 0 | − $1,770,000 | 1.0000 | − $1,770,000 |
| 1 | + 1,000,000 | 0.9259 | 925,900 |
| 2 | + 1,000,000 | 0.8573 | 857,300 |
| | | | + 13,200 |

We find that our present value is a positive figure; so we know that the cash flow produced more than 8%. We next test with a higher figure and try 10%, as follows:

| | | *Discounting at 10%* | |
|---|---|---|---|
| *Year* | *Cash Flow* | *Discount Factor* | *Present Value* |
| 0 | − $1,770,000 | 1.0000 | − $1,770,000 |
| 1 | + 1,000,000 | 0.9091 | 909,100 |
| 2 | + 1,000,000 | 0.8264 | 826,400 |
| | | | − 34,500 |

Since this present value produces a negative figure, we know that the cash flow produced less than 10% and the proper rate which will produce zero present value is somewhere between 8% and 10%, and that it would be closer to 8%.

If you have not had much experience with Discount Cash Flow analysis, perhaps you have lost track of what we have tried to accomplish. It might be restated as follows: When you go into a new project, you must make an estimate of the cash outlays each year and the cash returns, including those from depreciation, profit after taxes, and any remaining or salvage value. If the cash outlays are just equal to the cash returns, there would be no profit whatsoever. If the returns exceed the outlays, then the problem arises of what percentage return such a project represents. We find the answer by a trial and error method. We assume a return, and apply discount factors that apply to that return for the various periods of time. What is a discount factor? Merely the amount that would have to be invested at the particular rate to produce $1.00 at the end of the period. For example, the discount factor for the first year at 10% is 0.9091. The amount of 0.9091, invested for one year at 10%, will produce $0.0909 in interest, which, added to the $0.9091 principal, gives the $1.00.

In applying the Discount Cash Flow method, if the percentage we try at first does not work, we try again with another rate and the corresponding discount factors, until we come up with a percentage which equates the cash flow to a present value of zero. This is the profit rate which our project will produce and that which we are seeking.

Now we will take another example to show how the rate obtained by the discounted cash flow method ties in with our goal, cost-of-capital.

A new company is formed with $1,000,000 of common stock to go into a single venture. When the plant is built and operations are about to start the balance sheet in abbreviated form would be as follows:

| *Assets* | | *Liabilities* | |
|---|---|---|---|
| Plant | $ 800,000 | Common Stock | $1,000,000 |
| Current Assets | 400,000 | Current Liabilities | 200,000 |
| Total | $1,200,000 | Total | $1,200,000 |

Assume these additional facts:

1. Cost-of-Capital is estimated to be 10%, based on figures for established companies in the same line of business.
2. All earnings are paid out in dividends so that there will be no accumulated earned surplus and the long-term capital will remain at $1,000,000.
3. The plant is totally depreciated in five years by straight line depreciation, and there is no salvage value. Cash accumulated from depreciation each year is used to go into other projects with the same risk, so that the Cost-of-Capital will remain at 10%. The reason for this procedure is as follows: cash from depreciation either has to be accumulated, reinvested or paid back to stockholders as a return of their capital. For our purpose, it makes an easier example if we assume that it is

reinvested in a new project with equal risk.

4. The income from our original project decreases as the value of the net plant decreases.
5. The income and depreciation are received at the end of each year.

In order for our company to earn bare Cost-of-Capital,[20] its earnings available for common would have to be $100,000 annually. Part of this would have to come from our original project and the balance from reinvestment of the depreciation in new projects at the same rate as outlined in the first table above. As already stated, we will analyze the original project only and disregard the other projects in which the depreciation is reinvested. The plant and net working capital figures for this project would be as shown in the (first) table above.

| *Years* | *Plant plus Working Capital* | *Depreciation Reserve*[1] | *Net Plant* | *Working Capital* | *Net Plant plus Working Capital* |
|---|---|---|---|---|---|
| 0 | | | | | |
| 1 | $1,000,000 | $0 | $800,000 | $200,000 | $1,000,000 |
| 2 | 1,000,000 | 160,000 | 640,000 | 200,000 | 840,000 |
| 3 | 1,000,000 | 320,000 | 480,000 | 200,000 | 680,000 |
| 4 | 1,000,000 | 480,000 | 320,000 | 200,000 | 520,000 |
| 5 | 1,000,000 | 640,000 | 160,000 | 200,000 | 360,000 |

[1] To be reinvested in new projects as described above, but this is outside our immediate problem.

Since we have assumed that the project will earn the Cost-of-Capital of 10%, the income which the project would produce, along with the non-cash expense item of depreciation, will be as given in the Cash Flow table below.

In the righthand column is shown the cash flow. It is the algebraic sum of all outlays and cash returns for the project. In our example, cash outlays include the cost of the plant and working capital. Cash returns include the sum of income after taxes, depreciation and the return of working capital at the end of the period.

Now we are ready to proceed with the Discounted Cash Flow analysis. As you have noted, we have set up the figures so that the project will earn a preassumed Cost-of-Capital of 10%. If we find the discounted cash flow percentage which produces a zero present value is 10%, then the two concepts are comparable. Note that we are using an after-tax rate, since our cash flow allows for taxes as a deduction.

CASH FLOW

| *Year* | *Depreciation* | *Pre-Tax Income* | *Income Taxes*[1] | *After-Tax Income*[2] | *Cash Flow* |
|---|---|---|---|---|---|
| 0 | | | | | – $1,000,000 |
| 1 | $160,000 | $200,000 | $100,000 | $100,000 | 260,000 |
| 2 | 160,000 | 168,000 | 84,000 | 84,000 | 244,000 |
| 3 | 160,000 | 136,000 | 68,000 | 68,000 | 228,000 |
| 4 | 160,000 | 104,000 | 52,000 | 52,000 | 212,000 |
| 5 | 160,000 | 72,000 | 36,000 | 36,000 | 196,000 |
| | | | | | 200,000[3] |
| | $800,000 | | $340,000 | $340,000 | $340,000 |

[1] Assuming a 50% tax rate.

[2] Represents 10%, on net plant plus working capital, since we assumed the project would earn the Cost-of-Capital.

[3] Return of net working capital.

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[20] The goal should be above Cost-of-Capital for reasons explained in this chapter, but we will use this 10% figure for illustrative purposes.

The calculation of the discount rate to achieve a zero present value is shown in the first table below. We apply different rates by trial and error in order to arrive at the correct rate.

| | | *Discounting at 12%* | | *Discounting at 8%* | | *Discounting at 10%* | |
|---|---|---|---|---|---|---|---|
| *Year* | *Cash Flow* | *Discount Factor* | *Present Value* | *Discount Factor* | *Present Value* | *Discount Factor* | *Present Value* |
| 0 | – $1,000,000 | 1.000 | – $1,000,000 | 1.000 | – $1,000,000 | 1.000 | – $1,000,000 |
| 1 | 260,000 | 0.8928 | 232,000 | 0.9259 | 241,000 | 0.9091 | 236,000 |
| 2 | 244,000 | 0.7972 | 195,000 | 0.8573 | 209,000 | 0.8264 | 202,000 |
| 3 | 228,000 | 0.7118 | 162,000 | 0.7938 | 181,000 | 0.7513 | 171,000 |
| 4 | 212,000 | 0.6355 | 135,000 | 0.7350 | 156,000 | 0.6830 | 145,000 |
| 5 | 196,000 | 0.5674 | 111,000 | 0.6806 | 133,000 | 0.6209 | 122,000 |
| | 200,000 | 0.5674 | 113,000 | 0.6806 | 136,000 | 0.6209 | 124,000 |
| | | | – 52,000 | | + 56,000 | | 0 |

From these figures it can be seen that 12% is too high, and 8% too low. The third rate, 10%, is exactly correct. It produces a total present value of zero. This tells us that the project will earn 10% on the basis of this method of analysis. This is the same as the rate with which we started for our Cost-of-Capital. Thus, correctly applied, the Discount Cash Flow method of testing project profitability is compatible with our Cost-of-Capital goal.

| | *Capital Structure* | | *Rate* | *Interest and Earnings for Common* | *Cost-of-Capital* |
|---|---|---|---|---|---|
| Debt | $ 500,000 | 50% | 5% | $ 25,000 | |
| Common | 500,000 | 50 | 15 | 75,000 | |
| | $1,000,000 | 100% | | $100,000 | 10% |

| *Year* | *Project Cash Flow* | *$500,000 Principal* | *Borrowing Interest* | *Interest Tax Credit* | *Cash Flow with Borrowing* |
|---|---|---|---|---|---|
| 0 | – $1,000,000 | + $500,000 | | | – $500,000 |
| 1 | 260,000 | – 100,000 | – $25,000 | $12,500 | 147,500 |
| 2 | 244,000 | – 100,000 | – 20,000 | 10,000 | 134,000 |
| 3 | 228,000 | – 100,000 | – 15,000 | 7,500 | 120,500 |
| 4 | 212,000 | – 100,000 | – 10,000 | 5,000 | 107,000 |
| 5 | 196,000 | – 100,000 | – 5,000 | 2,500 | 93,500 |
| | 200,000 | | | | 200,000 |
| | 340,000 | — | 75,000 | 37,500 | 302,500 |

Note that we were careful to use items on the left hand side of the balance sheet which are provided by long-term capital. If we had used all current assets rather than just working capital, we would be using two different bases and the discounted cash flow percentage would not be compatible with our goal.

Now we will get back to our story about the application of the Discounted Cash Flow method. We have already mentioned that it is important to analyze how the items on the left-hand side of the balance sheet compare with the capital provided by long-term capital. There is the possibility of another more subtle and serious type of discrepancy arising from noncomparability when long-term debt is improperly handled. We will now explain this danger. Let's assume that we financed with 50% debt, which is repaid with an equal annual sinking fund in five years, and 50% common, so that our over-all Cost-of-Capital for investors is the same as our 10%. The figures would be as shown in the second table above.

The 10% is, of course, after taxes. It is the composite rate that would be paid to the security holders. An equivalent after-tax figure for the company assuming a 50% tax rate, would be 8.75%, since interest is deductible for tax purposes.

Incorporating the borrowing cash flow and its attendant tax credit into the original project cash flow, the figures would be as shown. (See bottom table, page 343.) The third column includes the fact that we received $500,000 as a loan and paid it off at the rate of $100,000 annually.

Testing the figures in the righthand column above for zero present value, we find that it is close to 16% as shown below.

| *Year* | *Cash Flow with Borrowing* | *Discounting at 16%* | |
|---|---|---|---|
| | | *Discount Factor* | *Present Value* |
| 0 | − $500,000 | 1.000 | − $500,000 |
| 1 | 147,500 | 0.8621 | 127,000 |
| 2 | 134,000 | 0.7432 | 100,000 |
| 3 | 120,500 | 0.6407 | 77,000 |
| 4 | 107,000 | 0.5523 | 59,000 |
| 5 | 93,500 | 0.4761 | 45,000 |
| | 200,000 | 0.4761 | 95,000 |
| | | | + 3,000 |

What has happened? Is the project really better than the 10% figure we previously found, and should we be more eager to accept it now because it seems to compare so favorably with our 10% Cost-of-Capital to investors, and the 8.75% after-tax equivalent for the company? The answer is obviously no. The earning power of the project is not better than it was originally. By mixing up the two sides of the coin—by introducing a Cost-of-Capital element, that is, the debt component—we have obtained a distorted answer. What, in effect, we have done is to doctor the figures to include the leverage of debt in them. If erroneously we choose to use such an approach, our percentage of about 16% would be more nearly comparable with the rate for our Cost-of-Capital on the common of 15%. In this particular case, the principal reason for the difference in these two percentages is the effect of the tax saving resulting from the interest charges.

In order to treat the situation correctly, our cash flow figures should be handled as they were originally. Don't mix up the financing method with the Discounted Cash Flow analysis. As far as the effect of interest on taxes is concerned, you can make allowance for that in your goal by using the after-tax equivalent rate to the company. How you handle it is immaterial as long as you do not allow for it twice.

The above may seem obvious, but we have followed through, step by step, so that you will see how to handle correctly the next complication, that is, financing by means of a lease. If you handle a lease situation the same way as we did at first for debt in the capital structure, you will obtain similarly misleading figures. Given below is a brief outline of the procedure to be followed in handling financing by a lease obligation.[21]

1. Discount at an interest rate at which the company could borrow money on a straight debt financing basis, the full schedule of lease payments covering financing,[22] to the point in time when the commitment is made. This gives the lump sum debt equivalent to the lease obligation.
2. Compute annual interest payments which would be made on the estimated debt and the applicable interest tax credits.[23]
3. Starting with the projected cash flow, including all leasing cash effects, make these adjustments:

---

[21] This is the approach suggested by William D. McEachron, Head, Long-Range Planning Group, Standard Oil Company (Indiana), as given in a speech before the American National Meeting of the Institute of Management Sciences at Chicago, Illinois, June 5, 1959. With regard to the financing cost elements of leasing, Mr. McEachron concluded that, even assuming that leasing could be done on as low an interest rate as borrowing, with accelerated depreciation, the cost elements favor ownership for depreciable property. With non-depreciable property, the added tax savings of leasing may, under some circumstances, show a lower cost, if the lease is for a sufficiently long term.

[22] Exclude non-financing charges in the lease payments, if any, to cover maintenance, etc. They should be included as an operating expense.

[23] This approach assumes that you make allowance for the tax savings of interest in your goal calculations.

   a. Add back full lease payments covering financing, at the time payments are made.
   b. Treat the estimated lump sum debt equivalent as a negative item at time of lease commitment.
   c. Deduct the tax credits due to interest at time incurred.
   d. Include any tax credits actually realized on the lease payments at the time realized.
4. Compute the discounted cash flow percentage on the adjusted cash flow schedule.

In effect, you compute the debt equivalent of the lease obligation and substitute it and its tax effects in the cash flow schedule in lieu of the lease payments themselves. Renewal options can be handled in a similar manner, except that the whole procedure would be built around the renewal date as the time of commitment. This procedure will give you the discounted cash flow rate of a project on a lease basis, which can be compared appropriately with the rate derived from an analysis of the cash flow on an ownership basis.

Perhaps it is difficult to see the significance of discussing how to treat lease financing. The same idea can be explained in a different way without reference to cash flow by the following simple example. In order to eliminate the cash flow problem, let's assume that we get all our capital back at the end of a year. Our profit goal for a proposed new project is 10% after income taxes at a 50% rate, figured on a capital structure as follows:

| | *Capital Structure* | *Rate* | *Cost to Company After Tax Equivalent* |
|---|---|---|---|
| Debt | 33⅓% | 5% | 0.83 |
| Common Equity | 66⅔ | 13.75 | 9.17 |
| | 100% | | 10.00 |

The investment is expected to be:

| | |
|---|---|
| Plant | $ 500,000 |
| Equipment, working capital, etc. | 1,000,000 |
| | $1,500,000 |

The equivalent after tax income, for the company is only estimated to be $120,000, or 8%; so we decide not to go into the project.

Then it is suggested that we lease the plant, with a lease rental equivalent interest rate of 6%. The balance sheet would only show the $1,000,000 investment in equipment and working capital, and the income would be $105,000.[24] This would give a rate of 10.50% on the $1,000,000 investment. Such a calculation would lead us into believing that the project was worthwhile. This false result is due to the fact that we based our calculations on the leverage effect of the lease.

To explain the idea further, let's assume that we financed the project with an equivalent amount of debt. We could have done the same thing incorrectly as above, with the debt method of financing, by taking the income after the interest changes. Allowing for the tax savings, the income on that basis would be $107,500,[25] or 10.75%. That, in fact, would be the amount available for the common equity, which, on the basis of our assumptions, should earn 13.75%.

Think of how the error mounts up as you lease a greater portion of the property. You could falsely show how a totally unsound project from a profit angle might look good. This is a seriously dangerous trap to avoid.

This concludes our brief remarks on the Discounted Cash Flow method of analysis of the profitability of a project. They, of course, give an oversimplification. As previously mentioned, it may be necessary to allow for the fact that income and some of the other items of cash flow are received on a continuous flow basis, and some in changing amounts over the period. This is handled by use of discount factors which make appropriate allowances. Such factors do not, however, invalidate the points that are made above regarding the comparability with our profit goal, and the proper application of discounted cash flow.[26]

[24] $120,000, less $500,000 times 3% (6% interest rate after 50% tax rate).

[25] $120,000, less $500,000 times 2.5% (5% interest rate after 50% tax rate).

[26] In the application of discounted cash flow, practical consideration must also be given to the pattern of earnings, particularly in the first years, in order to provide adequate earnings to make financing possible, so as not to hurt the company's financial standing.

To go further into an explanation of methods of appraising project profitability is outside the scope of this book. The above discussion was only for the purpose of showing how the formulas must be correctly interpreted in terms of the profit goal, which has to be derived from the righthand side of the balance sheet.

A little knowledge in this field can be very dangerous. You should proceed with caution and put in some real work so that you will visualize the broad implications of the figures; otherwise, you will come up with some very bad results. If you rely on someone else to do such calculations for you, watch out that they do not lead you into some of the types of discrepancies mentioned above. They may appear to make a project look interesting which is actually very unattractive.

## MAINTENANCE OF THE INTEGRITY OF THE DOLLAR

If you are experienced in the field of economics, you probably will have been in distress through most of this chapter, because the discussion has been on the apparent assumption that if a company earned somewhat more than its Cost-of-Capital on the book value of its assets, it would be successful. This, however, leaves out the problem of inflation.

As a simple example, let us suppose that a company had $100 in capital and that its goal was 10% after taxes. Then, if it earned ten dollars on this capital, it would achieve its goal. But let us suppose that the price level doubled and it still only earned ten dollars. Then the poor investor would only be able to buy one-half as much with his return as he did before inflation. After all, money is only a medium of exchange and the investor is interested in maintaining his ability to buy goods. Therefore, the goal should be applied to the $100 of capital revalued after inflation at $200. Ten percent on this figure produces twenty dollars, which would be worth the same, in terms of goods, as ten dollars before inflation. This would be keeping the investor whole. This is what is meant by maintaining the integrity of the dollar.

If there have been great technical advances in an industry so that its old plant has become more obsolete than is covered by depreciation, then the investors will have to take their losses. That is a capital risk which they should have evaluated before they put up their money. However, they should be allowed a chance to protect themselves against a change in the value of the dollar. Therefore, if properly applied as a test to see how much a company should earn on the existing plant to meet its Cost-of-Capital goal, the assets should be valued on a reproduction cost new basis less depreciation. This would take care of changes in the value of the dollar as well as wear and tear, obsolescence and other causes of depreciation.

This problem, of course, does not arise when using Cost-of-Capital as a goal in deciding on whether to go into new projects, because new projects are built at the current price level. Since we have been concerned primarily with setting the goal for new projects, we have left this subject until now. Furthermore, while an important factor, it was felt that it would add to your confusion to discuss it earlier. It is of importance for industrial companies in Return-on-Investment analysis. Relating current earnings to past investments on the basis of balance sheet figures may reflect very misleading results.

The subject is particularly important in the utility industry, where regulation establishes an allowable return on a rate base. Proper regulation in carrying out the principle that regulation is a substitute for competition, should give effect to the change in the value of the dollar in the rate base. In competitive industry, the interplay of economic forces of necessity results in adjustments to give effect to such a change. Management, in evaluating the success of past results, must have in mind that returns on already invested capital should recognize this economic fact of life. So, also, should it be recognized in regulated industries, in order that prices in those industries will be in economic equilibrium with the rest of economy.

The same idea, of course, applies to the matter of the proper allowance for depreciation in order for it to replace the equivalent property and not just a dollar amount. Bookkeeping depreciation allocates the cost of the property to periods of time. During inflation, provision for such depreciation does not provide sufficient dollars to replace the economic power of the original investment. That raises the question of whether a profit exists, in a real sense, without the full recovery of the equivalent economic power. This intriguing subject, termed economic depreciation, is a study in itself. We will not attempt to go into it, but this is not to suggest that its importance should be minimized.

## CONCLUSION

No effort has been made in this chapter to discuss many other factors which management may have to consider in determining expansion policies. But it should not be inferred that the writer believes that other factors do not exist.

A project, to be successful for our economy, must satisfy a real need. However, since ours is an incentive system with the prospect of profits as the stimulus, an important test is whether the total income is sufficient to pay at least all operating costs and capital costs. Mere growth in size of a corporation may be flattering to the management, but in itself it is no proof that capital is being economically directed. Expansion, on the excuse of saving markets from competitors, by itself is quite dangerous.

In a large company, there are many men in top positions who have to make decisions regarding the direction of the flow of capital. They cannot all be experts in finance. They have to have broad knowledge in many fields. However, because of its grave importance to our economic system as a whole, and to the stockholders in particular, it does appear that those charged with this responsibility should at least have a clear understanding of this important element—the Cost-of-Capital.

### *Reducing the Cost-of-Capital*

A thorough knowledge of Cost-of-Capital should not only help your company in directing its capital expenditure, but it may also suggest ways to reduce Cost-of-Capital within the field of financial policy. By now, you probably can list the ways yourself. As a reminder, they are:

1. Provide an adequate investor relations program so that investors will be thoroughly informed about your company and so that they will not add an element of risk by their lack of information.
2. Establish the most appropriate common dividend policy in keeping with the nature of your company which will best satisfy the requirements of investors, and produce the highest price for your common stock over the long run. This should not be interpreted as necessarily meaning a high payout, and it must not be viewed in terms of a quick market price movement but, rather, from the long run. The extent of payout will depend on the nature of the company.
3. Maintain a sound financial policy in order to eliminate added risk of too much senior securities over the long run. Weigh the judicious use of debt and preferred stock where applicable.
4. When financing, weigh properly all the methods available, having in mind the benefit to the common stockholders, so that capital is raised on the best basis over the long run.
5. Be sure that when you go into new projects proper profit goals are established and met, so that investors will not need to increase their evaluation of the risk factor due to management errors.

Throughout the chapter it was stressed that the most important thing in determining Cost-of-Capital is an understanding of the principles involved. Otherwise, hopelessly meaningless results will be obtained. This relates equally to the *application* of Cost-of-Capital. If you believe these statements, then the chapter has been worthwhile. You are on the way to learning how to use a tool that must be applied by someone in the management of every company. The Summary Outline which follows may be helpful when you need a quick review.

### SUMMARY OUTLINE—COST-OF-CAPITAL

| *Capital Structure* | | *Cost Rates* | *Total* |
|---|---|---|---|
| Average proportions of appropriate long-term securities over a period of years. May include 3 basic types of long-term securities: | | Based on net proceeds received from sale of new issues of comparable quality, after allowing for financing costs; or equivalent based on outstanding issues with appropriate allowance for underpricing to cover pressure, financing costs, etc.<br>Current—not "spot" or historical—over sufficient number of years representing average market conditions for raising capital. | |
| Long-term debt | 00.% times | 0.00% (Yield from bond tables based on interest coupon and net proceeds per $100 of bonds) | = 0.00 |
| Preferred stock | 00. times | 0.00% (Dividend rate divided by net proceeds per share) | = 0.00 |
| Common stock and surplus | 00. times | 0.00% ("EXPECTED" earnings per share divided by net proceeds per share) | = 0.00 |
| | 100 | | |
| COST-OF-CAPITAL . . . . . . . . . . . . . . . . . . . . | | | C% |

GOAL: A company should aim to earn somewhat above the Cost-of-Capital. A profit is earned only after Cost-of-Capital has been met. Furthermore, in new projects there is usually more of a lag than anticipated before operations become as profitable as estimated. And particularly during good years, a company must earn more than the Cost-of-Capital in order to compensate for bad years.

*CHAPTER XI*

# Tests of Good Financial Management

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The purpose of this chapter is to provide a brief review, or what might be termed a check list, in broad terms. Possibly, it may serve as a stimulus to further study in the field of finance. It includes a few comments about our system of private capital.

There will always be some people who defy sound principles of finance. Unfortunately, in publicly-owned companies, their actions will hurt others; our economy will also be hurt. A few, in spite of unsound policies, will prosper, at least temporarily. They may hit a "gold mine" of some sort which will overcome the disadvantages of unsound finance. They may avoid the ultimate consequences by retiring before their mistakes come home to roost. Errors in long-term financing seldom prove immediately disastrous; otherwise no one would be so blind as to follow them. Particularly to be guarded against are: overoptimism during a boom, the urge to follow a course based on temporary expediency and "gimmick" approaches.

## ADVANTAGES OF SOUND FINANCIAL POLICY

To appreciate further the advantages of sound financial policy, we might think of three groups affected thereby. They encompass our entire economy—the customers, the employees and the investors.

In competitive industry, the customers do not generally suffer if a company's operations are curtailed because of unsound financial policies. A competitor will step in and supply the demand. However, a large segment of our industry is regulated as a monopoly, or at least a partial monopoly within its own field. This segment includes the regulated industries: the public utilities—electricity, gas, telephone and water—the railroads and the airlines. Adverse financial policy will not necessarily hurt the customers in the short run, because new securities can sometimes be sold by disregarding what has happened to the unfortunate past investors who have already sunk their money in the company and cannot withdraw. There is a time when such a company ultimately cannot finance on a satisfactory basis. Obviously, then, if new capital is needed for expansion, the customers suffer.

Unions protect employees, but a financially healthy company is far better for employees in terms of steady employment, opportunities for advancement and fringe benefits. This is becoming increasingly important with the advent of profit-sharing plans. The employees do have an interest in sound financial health.

Of course, the persons most directly hurt by unsound finance are the investors. Their welfare must be evaluated both in terms of the individual and of the welfare of our economy. As long as we have a system of free private capital, the investors play a most important part. They must be treated fairly in all three phases of finance—financial policy, investor relations and profit goals, in order for our system of private capital to prevail.

## CLUES TO UNSOUND FINANCIAL THINKING

Throughout the book there were references to types of comments by management which, standing alone, may indicate poor financial management. While that is the negative approach, nevertheless, it may be interesting to look at some of those comments gathered together and thus to recall the type of attitude which may frustrate sound financial management and be viewed as a danger signal.

> "There are two points of view: what is good for the company and what is good for the stockholder."
>
> "The stockholders just won't understand; so why tell them?"
>
> "We have nothing interesting and favorable to tell about our company at this time. Therefore, we will cancel our scheduled appearance at the meeting of the analysts' society."
>
> "Our situation is too complicated to try to explain to financial analysts at this time."
>
> "Bonds are not due for 25 years; we will be retired by then. Let our successors worry about it—we raised the capital."
>
> "We need to be most concerned with the provisions in our new long-term debt issue which affect our present operations."
>
> "Debt is a cheap form of capital and the interest charges are deductable for tax purposes; therefore, let's use all the debt we can while conditions are booming and debt is easy to get."
>
> "On the basis of our forecasts for the next five years, we can certainly carry more senior securities."
>
> "Preferred stock is neither fish nor fowl."
>
> "Our major consideration in dividend policy is the need to conserve cash and obtain funds for construction from retained earnings rather than selling common stock."
>
> "We prefer a direct offering for the principal reason that a rights offering causes more dilution."
>
> "We are forced to expand in order to keep our markets from competitors even though the profit margin appears slim."

## WHO SHOULD DO WHAT?

Since we are now finishing the book, there is given below a skeleton outline of some of the things each person in a company, having either a direct or indirect relation to finance, should do in carrying out his part. In the introductory chapter, it was stated that today an understanding of finance should not be limited to a few.

### *Directors and Principal Managing Officers*

The Directors, Chairman, President, Executive Vice President, General Manager—who will pass on the recommendations of the principal financial officers—should:

1. Know that financial policy includes long-term financing, investor relations, and Cost-of-Capital; have an understanding of the basic principles involved in each.

2. Allocate some time to appear before gatherings of financial people in order to carry out an investor relations program.
3. Understand the meaning and magnitude of Cost-of-Capital in order not to direct capital uneconomically; promote a program of company training so that there is an understanding of the general magnitude of Cost-of-Capital and proper profit goals throughout the organization. This will include plant and division managers. Establish performance analysis based on return on investment.
4. Know enough about the qualifications for a top financial executive to pick a qualified man to fill the position, a man of breadth as well as one capable of penetrating thought, not an accountant or lawyer in the strict sense. Training in both fields is obviously a good background, but neither is enough to make a well-rounded Financial Vice President.
5. Have all financial functions either directly under the principal financial officer, or at least closely coordinated by him.
6. Permit sufficient freedom of time on the part of the principal financial officer for him to maintain his contacts in the financial community and keep up on current thinking and new findings on financial subjects.

### *Principal Financial Officer*

Whatever his title, the principal financial officer should:

1. Know the principles and details of the three interrelated subjects—financial policy, investor relations and Cost-of-Capital.
2. Know the financial community and where to get advice, how to get it, and the prejudices and biases of those from whom he seeks advice.
3. Be open-minded to all new ideas but test them on the basis of sound principles.
4. Make sure all of those who work for him see how the details they perform fit into the ultimate goals to be accomplished.

### *Officers with Positions Directly Related to Finance*

The Treasurer and Comptroller and their assistants and staff, tax experts, and legal aids should:

> Know the over-all broad picture of the job to be done by the principal financial officer, its value to the company and our economy, and how each job ties into the whole picture.

## ALWAYS MORE TO BE LEARNED

The sound principles persist, but there are changing markets and circumstances, new innovations to be thought through and further research to be done on many financial subjects in order to get the right answers. If you are an expert and have some juniors working for you, you may wish to use what follows for the purpose of pointing out to them what they might do in order to increase their knowledge:

1. Perhaps it is too obvious to suggest a good business newspaper or magazine on business. We previously mentioned the monthly review of the Federal Reserve Bank of New York. All that is necessary to do is to skim through such material, and look for such things as:
   a. Examples of financial principles. If a company went broke, why? Too much debt? Projects not sufficiently profitable? Other poor financial policies?
   b. Stories on proxy fights. Did the company ignore the investors' point of view when it was in good shape?
   c. New ideas on finance. Weigh whether they are sound.
   d. A sense or "feel" of securities' markets.

   Study other books and pamphlets. There are many special fields of finance which are covered in the myriad of books, research pamphlets and articles on finance. The only possible way a person can become steeped in finance is through a forced reading program during the younger years.

2. Some relief may be needed from heavy reading in finance. If so, there are two unusually interesting and easily read books which will be bound to add to anyone's background on finance, even an expert's. They are: *Wall Street Men and Money* by Martin Mayer (Harper and Brothers revised edition, 1960) who is perhaps better known for the best seller he wrote about the advertising business, *Madison Avenue, U.S.A.*; and *The Seven Fat Years* by John Brooks (Harper and Brothers, 1958). Mr. Brooks is a novelist and a writer for *The New Yorker* magazine, and *The Seven Fat Years* is a compilation of profiles he wrote for that magazine on people in finance.
3. Encourage personal visits with financial experts and financial institutions.
4. If courses are available on finance, encourage your men to take them. They may include: accounting principles, an absolute essential as a background for financial policy; security analysis, to show how the prices of securities are determined; principles of money and banking, to explain how our monetary system works; corporate finance; and principles of economics, taxation and law, as worthwhile basic foundations.
5. If your company is large enough to be able to afford it, take on a young man, or pick out one from your organization. If you choose one from the outside, a few years of security analysis experience will provide a good background. Let him do research on financial subjects which you should know about but have not had time to study. It is fine training for a future financial officer. Encourage the writing of articles and the giving of talks. These activities act as an excellent stimulus to learning.

## OUR SYSTEM OF PRIVATE CAPITAL

Since this book has been about financing in our system of private capital, a few words about this system do not seem amiss. If it is not a good method of organizing society, it eventually will fall by its own weight. As indicated in the introduction, in order to be good, a system should produce the most goods and services with the least effort, and allocate them fairly among the elements of production and the people. It should have one other important ingredient: it should permit the maximum of individual freedom.

However, even if our system of private capital does achieve these goals best, the system will not continue in existence by itself. There are many people who do not realize its benefits, know how it works, and the need of fair profits to keep it going. Whenever it seems to falter, they are only too anxious to seek a new system, without actually knowing whether the change would be to their benefit. There are those who positively attempt to replace it. By taking advantage of all that our system of private industry has developed, they might appear highly successful temporarily. That is the danger. It is important for those who do appreciate our system to do their part in telling a convincing story whenever the opportunity presents itself. This task requires a ready answer to give to detractors; yet it isn't easy to put one into words. A statement which may be helpful was made by William McC. Martin, Jr.,[1] Chairman of the Board of Governors of the Federal Reserve System:

> Not long ago an economic historian, Robert Heilbroner, declared that man has found, over the centuries, only three ways of insuring the execution of the thousands of intertwined tasks—the disagreeable ones as well as the pleasant ones—

---

[1] From an address before the Economic Club of New York, March 12, 1957.

that must be done each day to keep human society from breaking down.

One way has been to organize society around the forces of tradition, by handing down the varied and necessary tasks from generation to generation according to custom and usage; son follows father, and a pattern is preserved. Thus, n India, until recently, certain occupations were traditionally assigned by caste.

The second way, also in use for countless centuries, has been to use the lash of central authortarian rule to see that the necessary tasks get done. That was the system used to build the pyramids of ancient Egypt. It is the system the Soviet government uses today to get its Five-Year Plans carried out.

The third solution to the problem of economic survival is the market system. It achieved general acceptance only a couple of centuries ago, and yet it revolutionized civilization in the Western World.

A market provides a means of exchanging goods, but a market system does considerably more. It provides a mechanism for sustaining and maintaining an entire society. It constitutes a way of life that affords freedom that cannot exist in a society run by tradition or the rule of authority. For, in the market system, the lure of gain, not the pull of tradition nor the whip of authority, steers each man to his task. And yet, although each may go wherever he thinks fortune beckons, the interplay of one man in competition with another results in the necessary tasks of society getting done.

Now we know from our experience that the functioning of markets is not always good. Markets can, in fact, function very badly, particularly when they are dominated by monopoly, by speculative excesses, or by inflationary forces. Those of us who are truly concerned with utilizing the resources of the market must devote our energies to the promotion of competition, the restraint of speculative excess, and the maintenance of the stability of the dollar.

I would like to add only a comment to the statement about competition. It should be vigorously maintained through forceful application of the Anti-Trust Laws, but this does not mean that all mergers should necessarily be prevented. They may be beneficial by increasing efficiency, or they may assist in curing overproduction when mistakes have been made. Mergers should only be prevented when they will restrict competition.

Above all, industry should not be made to compete against unfair competition—that is, competition fostered by government through subsidized capital or tax-free operations. That is the old giveaway gimmick to favor special groups. Government has its proper functions to perform, but private, taxpaying capital cannot be expected to, nor should it have to, compete against government-subsidized industry. This is unfair, unnecessary and uneconomical competition which can wreck our system and hurt the taxpayers.

A final word about finance—it is an interesting and stimulating field of endeavor. If you can see its importance, see it from all its angles, then both the broad principles and the details stand out in clear perspective, and the everyday work becomes most enjoyable. If the job is done with the understanding it requires and deserves, you should receive the satisfaction of knowing that not only will your company, its employees and customers benefit, but so will the entire free enterprise system.

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